PhD Thesis

ENFORCEABILITY OF CREDIT RISK MITIGATION TECHNIQUES IN THE CONTEXT OF BANK INSOLVENCY AND RESOLUTION

by

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This thesis is submitted to the University of Warwick in support of my application for the degree of Doctor of Philosophy. It has been composed by myself and has not been submitted in any previous application for any degree.

Mis padres

Palabras faltan para expresar el agradecimiento debido por vuestros esfuerzos.
La ausencia hubiera impedido todas aspiraciones.
Certeza es que mi corazón se encuentra con vostros.

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Abstract

Before the financial crisis of 2007, financial market participants enjoyed almost unrestricted autonomy in devising techniques to contractually allocate risks and consequences of default. Market participants document derivatives and securities financing transactions under a standardised framework agreement. These agreements promote certainty amongst users. The main consideration is the management of default and the subsequent allocation of costs. It mitigates credit risk by providing a contractual self-help remedy whereby transaction tos with defaulting counterparties are terminated or accelerated, valued and amalgamated or set off to produce one single net obligation. This obligation is owed by the party with the smaller notional amount. The payment, however, is subject to insolvency dispostion constraints. Thus, the collection of this amount is uncertain; however, its benefit is the certainty that the obligation will be a net figure. This mechanism is known as close-out netting and has been adopted for agreements governing a variety of contracts, including derivatives and securities financing transactions.

Without close-out netting, there is a risk that the insolvency practicioner enforces only profitable transactions while rejecting, disclaiming or reputating transactions unprofitable for the estate. In effect, close-out netting reduces the non-defaulting party's exposure to the defaulting party to the net figure. Any creditor that must perform on its obligations while being unable to enforce its claims would experience significant distress. It suggests that the mitigation of credit risk reduces consequetial defaults– thereby promoting to financial stability. Therefore, policymakers and regulators widely promote this mechanism as contributing to financial stability by mitigating the effects of a default. This promotion takes the form of a carve-out from the scope of otherwise compulsory suspensions and restrictions that apply in insolvency. Thus, close-out netting can operate despite any actual or impending insolvency proceedings or restructuring measures.

Financial institutions can reflect their exposure on a net basis. Close-out netting thereby ensures that potential loss will never exceed the net figure. However, it does not entail payment. Creditors benefiting from close-out netting must prove their claims like any other creditors in insolvency. The recovery depends on the relative priority within the creditors' hierarchy. Therefore, close-out netting arrangements are often combined with security in the form of collateral whose value can be realised to discharge the net amount obtained after the application of close-out netting.

Critics claim that close-out netting undermines the objectives of insolvency, is prejudicial to the general body of creditors and is, in fact, detrimental to financial stability. The financial crisis of 2007 seemed to support this rhetoric. In accordance with their contractual rights, parties sought to terminate their relationships with failing financial institutions as soon as possible, thereby causing payment obligations and appropriating assets producing a result akin to a bank run. The effect was that authorities were unable to intervene and rehabilitate the affected financial institutions enable them to continue operating as a going concern. This position seems irreconcilable with the presumed beneficial effects of close-out netting. Not surprisingly, the voices that seek to abolish the carve-outs of derivatives and their framework agreements became louder and more assertive.

To date, there is no analysis of the merits of close-out netting and collateral in the context of bank insolvency and resolution under English law. This thesis fills this gap by challenging various of the academic arguments against netting, discerning the principal risks and exploring how the evolving bank resolution regime mitigates adverse implications. It argues that contrary to critics' conception, close-out netting deprives neither the debtor nor the general body of creditors of assets or any other rights. Nor does it alter the insolvency hierarchy or otherwise offend insolvency law. English law does not prohibit clauses permitting termination due to insolvency. Such termination rights are firmly entrenched in the principles of contractual freedom and commercial reasonableness. This does not contradict, however, the argument that there are good reasons to temporarily restrict enforcement in order to stabilise financial institutions and thereby promote financial stability. Financial derivatives and securities financing transactions are utilities for financial institutions and integral to their survival, which was also agreed on a global level. Implementation of these standards has however gone too far. This regime also introduces administrative powers which undermine the regulatory framework in Europe and are detrimental to the international competitiveness of EU financial institutions.

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Table of Authorities

Cases

Table of Abbreviations

2004 Regulations	SI 2004/1045, Credit Institutions (Reorganisation and Winding Up) Regulations 2004
2008 Act	Banking (Special Provisions) Act 2008 (c 2)
Bank Administration Procedure	Bank Administration Procedure under Part 3 of the Banking Act 2009
Bank Insolvency Procedure	Bank Insolvency Procedure under Part 2 of the Banking Act 2009
Banking Reform Act	Financial Services (Banking Reform) Act 2013
Basel Accords	Banking regulations (Basel I, II and III) as prepared by the BCBS
BCBS	Basel Committee on Bank Supervision
BCD	Directive 2006/48/EC, Banking Consolidating Directive
BIPRU	Banking and Investment Firm Prudential Sourcebook
BoE	Bank of England
BRRD	Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council Text
CASS	Client Assets Sourcebook
CCP	Central counterparty
CRD IV	Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC
CRD IV Framework	CRR and CRD IV
CRR	Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for

	credit institutions and investment firms and amending Regulation (EU) No 648/2012
CSA	ISDA Credit Support Annex
CSD	ISDA Credit Support Deed
CVaR	Credit Value at Risk
EAD	Expected Loss at Default
EBA	European Banking Authority
ECB	European Central Bank
EMIR	Regulation 648/2012, European Market Infrastructure Regulation
FCA	Financial Conduct Authority
FCARs	Financial Collateral Arrangements (No 2) Regulations 2003
FCD	Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements
FMI	Financial Market Infrastructure
FSA	Financial Services Authority
FSB	Financial Stability Board
FSCS	Financial Services Compensation Scheme
FSMA	Financial Services and Markets Act 2000
GMRA	Global Master Repurchase Agreement
GMSLA	Global Master Securities Lending Agreement
ICB	Independent Commission on Banking
ICMA	International Capital Markets Association
IM	Initial Margin
Investment Bank Special Administration	SI 2011/245, Investment Bank Special Administration under the Investment Bank Special Administration Regulations 2011
ISDA	International Derivatives and Swaps Association, Inc.
ISLA	International Securities Lending Association
LBIE	Lehman Brothers International Europe
MiFID	Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU

MiFIR	Regulation (EU) No 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Regulation (EU) No 648/2012
MPOR	Margin Period of Risk
MRA	Master Repurchase Agreement
MREL	Minimum Requirements for Eligible Liabilities
MSLA	Master Securities Loan Agreement
MSFTA	Master Securities Forward Transaction Agreement
MTF	Multilateral Trading Facility
Order	Banking Act 2009 (Restriction of Special Bail-in Provision, etc.) Order 2014
OTC	Over-the-counter
PRA	Prudential Regulatory Authority
PRIMA	Place of the Relevant Intermediary Approach
Repo	Repurchase Agreement
Risk Mitigation RTS	Commission Delegated Regulation (EU) 2016/2251 of 4 October 2016 supplementing Regulation (EU) No 648/2012 of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories with regard to regulatory technical standards for risk-mitigation techniques for OTC derivative contracts not cleared by a central counterparty
RWA	Risk Weighted Assets
RWuD	Directive 2001/24/EC of the European Parliament and of the Council of 4 April 2001 on the reorganisation and winding up of credit institutions
Settlement Regulations	Insolvency (Settlement Finality) Regulations 1999/2979
SFD	Directive 98/26/EC of the European Parliament and of the Council of 19 May 1998 on settlement finality in payment and securities settlement systems
SLB	Securities Lending and Borrowing
SI	Statutory Instrument
SIFMA	Securities Industry and Markets Association
Special Administration (Bank Insolvency)	SI 2011/45, Special Administration (Bank Insolvency) under the Investment Bank Special Administration Regulations 2011

SRB	Single Resolution Board
SRM	Single Resolution Mechanism
SSM	Single Supervisory Mechanism
TLAC	Total Loss-Absorbing Capacity
VM	Variation Margin

Chapter 1
Introduction

This thesis will investigate the enforceability of credit risk mitigation techniques in the context of insolvency and resolution of financial institutions. There is an apparent mismatch between the purported benefits and the lessons obtained during the financial crisis of 2007. The restriction of credit risk mitigation techniques has therefore been widely advocated. In this analysis, special attention will be paid to the somewhat esoteric concepts of close-out netting and collateral arrangements in respect of financial derivatives and securities financing transactions. Therefore, this first chapter seeks to set out the objective of this thesis and introduce the fundamentals of financial contracts, close-out netting and financial institution resolution. It assesses the legal framework promoting and restricting the use of credit risk mitigation techniques both before and after the financial crisis of 2007, since the latter draws the balance between the enforceability of close-out netting and the need to rescue financial institutions. The remainder of this chapter is structured as follows.

The first section provides the general background information. In this context, it is germane to briefly illustrate the need for financial contracts and credit risk mitigation techniques. It will also reveal the fundamental problem that exists between close-out netting and financial stability. This criticism is often convoluted with other misconceptions, which will be introduced and discussed in 2.3 and 2.4 below.

The second section examines the use and role of financial contracts. It attempts to define the term financial derivative, which seems elusive given its various appearances. The most fundamental provisions under the master agreements to ensure enforceability are also introduced. Subsequently, this section will introduce the concepts used to mitigate credit risk other than netting, which are often used in conjunction with derivatives. The term financial contracts encompasses repurchase agreements and securities lending agreements, which will be examined in this section. In this way the special nature and risk profile of derivatives can be properly appreciated.

The third section introduces the concept of close-out netting and collateral. Most academic literature does not sufficiently reflect on these mechanisms. This section seeks to fill this gap by thouroughly examining them from an English law perspective. This is important because the failure to appreciate its objective and actual effect results in widely held misconceptions.

The fourth section presents the fundamentals of resolution. The novel resolution regime permits authorities to intervene before insolvency; however, its effects resemble actual those of insolvency. It empowers administrative authorities to intervene, and to amend and suspend contractual rights. This new regime will be discussed in detail in section 4.3 and Chapter 5. The fifth section contains the problem statement, methodoly and structure of this thesis.

1.1 Background

Financial contracts are integral for the financial liquidity and risk management of financial institutions and other market participants. As a consequnce, financial contracts promote a more efficient allocation of resources and therefore serve a socio-economic benefit. Whilst reducing risk, financial contracts expose the parties to the counterparty's ability to perform its obligations. In other words, financial contracts expose the parties to the counterparty's credit risk. To mitigate credit risk, the market developed the concept of close-out netting, whereby all transactions are terminated, valued and netted to form a single net amount. If this amount is negative, the defaulting party has an obligation to the non-defaulting party. The opposite is true if the single net amount is positive. The actual payment of the single net sum does not form part of close-out netting. In practice, a non-defaulting party may be unable to collect this amount in whole or part if the counterparty is subject to insolvency proceedings.[1] In addition, parties exchange security, which can be used upon the default to discharge the counterparty's obligations.

Due to the beneficial purpose of financial contracts and the credit risk mitigating effect of close-out netting, legislators and regulators have actively promoted the latter. This recognition resulted in a reduction of the regulatory capital requirements, ie the capital that must be put aside to absorb any potential losses resulting from risky transactions. During the financial crisis, regulators recognised however that the early termination represents an obstacle when rescuing or rehabilitating distressed financial institutions. In many cases, it was recognised that financial contracts gave a false impression of security. For instance, hedges were lost when counterparties failed or the hedges themselves proved not to perfectly mitigate the intended risk in extreme cases (such as during a financial crisis). Moreover, financial contracts allowed the excessive build-up of hidden and at times concentrated risk.[2] Academics challenged the legitimacy of close-out netting as it is often falsely perceived as offending mandatory insolvency law by depriving both the debtor and the general body of creditors of assets.[3]

In the aftermath of the financial crisis of 2007, legislators and regulators sought to remediate the short-comings in the legal and regulatory framework and to promote a stable and robust market. In light of the aforegoing, it is unsurprising that arguments advocating the limiting the use of financial contracts and close-out netting arrangements gained momentum. Arguably, the general understanding of both financial contracts and credit risk mitigation techniques suffers from conceptual weaknesses that misinform the evolving regulation. If follows from the misperceived or exaggerated focus on risk. An in-depth discussion of the measures that were implemented after the financial crisis to promote the transparency of bilateral and exchange traded financial contracts is

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1 Section 2.4

2 See Dan Awrey, 'The dynamics of OTC derivatives regulation: bridging the public-private divide' (2010) 11(2) European Business Organization Law Review 155, Frank Partnoy, 'Public-private relations in a transnational private regulatory regime: ISDA, the state and OTC derivatives market reform' (2012) 13(3) European Business Organization Law Review 309 and Bruno Nikolić, 'Rise and fall of regulatory state in financial markets' (2013) 28(1) Journal of International Banking Law and Regulation 1, 7

3 See section 2.4

beyond the scope of this thesis and will mentioned incidentally.[4] Similarly, measures that seek to interpose a third party in bilateral transactions such that the credit risk is mitigated will not be discussed.[5] The focus lies on the contractual reduction of credit risk by way of close-out netting and collateral.

A significant reform after the financial crisis of 2007 concerns the rescue or orderly wind-up of financial institutions. This is referred to as recovery and resolution. Whereas the former is applicable when the financial institution is severly distressed but viable, the latter seeks to wind-up the financial institution without causing threatening that the distress may transcend the financial institutions without recourse to public funds. It entails two stages. The planning and adoption of recovery and resolution measures. With the recovery and resolution measures, legislators conferred substantial powers to authorities. These powers involve the right to expressly override, cancel, defer, stay or suspend credit risk mitigation techniques. The intrusive intervention powers of resolution authorities apparently reverse the process of incremental protection of credit risk mitigation techniques and the resulting certainty established by market participants, inevitably leading to uncertainty.

Therefore, it is necessary to analyse the unique features of financial contracts and merits of close-out netting. Financial contracts can be transacted bilaterally or on an exchange. The latter type is highly standardised, whereas the former allows parties to structure their financial contracts to better meet their requirements. A plethora of public and private entities enter into financial derivatives and securities financing transactions.[6] The list includes financial institutions such as investment firms and credit institutions; insurance undertakings and pension funds; ordinary companies; investment funds; individuals, trusts and charities; and sovereign entities such as central banks, treasuries, sovereign wealth funds and even deposit guarantee schemes. Financial contracts have a myriad of legitimate applications; however, they can be abused to facilitate illegitimate schemes. For instance, financial contracts can operate similarly to insurance contracts, namely, a sum is paid or an asset is delivered upon the occurrence of a certain event. It promotes certainty that one will be able honour obligations in future. This technique is commonly referred to as hedging. In contrast to an insurance policy, market participants can be given the option to exercise their right to receive payment or delivery upon the occurance of a cetain event.[7] Moreover, they can be structured more broadly than traditional insurance policies. Others may seek to use financial contracts to invest while assuming risk. Ostensibly, these opposing objectives are not mutually exclusive. In other words, while one

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4 See Regulation (EU) 2015/2365 of the European Parliament and of the Council of 25 November 2015 on transparency of securities financing transactions and of reuse and amending Regulation (EU) No 648/2012 and Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories

5 Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories

6 See Simon Firth, Derivatives: Law and Practice (Sweet & Maxwell 2003), the Introduction to Alastair Hudson, *The Law on Financial Derivatives* (6th edn, Sweet & Maxwell 2017), Paul Harding and Christian Johnson, *Repo Master Agreemetns: Existing market practice for legal documentation in Europe and the USA* (3rd edn, Harriman House 2017) pp. 1 et seq and Paul Harding and Christian Johnson, *Mastering Securities Lending Documentation* (Prentice Hall, 2010) pp. 14 et seq

7 It is often contended that due to the absence of an insurable interest, derivatives do not qualify as insurance contracts. In England, the provision of derivatives do not attract an insurance licence

party seeks to hedge, the other willingly assumes the risk.[8] Financial contracts can also be used to manage liquidity.

The documentation differs from other documentation used in financial markets. In contrast to loan agreements, or other debt or capital markets documentation, the terms of the master agreements governing financial contracts apply bilaterally.[9] It shall be noted that participants in financial markets face the risk that their counterparties may become unable to honour their obligations. Market participants have therefore developed credit risk mitigation techniques. These techniques provide a contractual self-help remedy whereby transactions with defaulting counterparties are terminated or accelerated, valued and amalgamated to produce or replaced by one single net obligation owed to the party with the larger notional value. This mechanism is known as close-out netting and has been widely adopted for agreements governing a variety of contracts. It is therefore useful to consider which transactions are commonly subject to these credit risk mitigation techniques as well as their integral role and immeasurable value for financial institutions and the economy at large.

Crucially, it allows addressing credit or counterparty risk by introducing additional events of default and defining thresholds that would result in early termination. Against this background, it can be argued that the overall benefit of master agreements is the ability to promote certainty. For instance, Parties to an ISDA agreement can

> effectively understand and manage the extent of credit risk, by ensuring that counterparties know which events will terminate the agreement, or trigger [events of default], and what levels of default are required.[10]

This understanding, mitigation and allocation of risk is a central reason for the growth of financial derivatives markets. Ostensibly, this discussion applies *mutatis mutandis* to the benefits of the GMRA and GMSLA in relation to securities financing transactions discussed below.[11] In contrast to exchange-traded derivatives, the relation is governed by a membership agreement and rulebook which cannot be amended to reflect the risk of the counterparties.[12]

There are various means to mitigate credit risk. Close-out netting is a form of credit risk mitigation.[13] Close-out netting amalgamates or sets off, depending on the master agreement type, the value of countervailing claims to form a single net obligation, thereby reducing exposure to the distressed counterparty. Market participants often combine this mechanism with the posting of security, which is referred to as collateral or margin in the context of financial contracts.[14] Not surprisingly, prudential

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8 For the fundamentals, see Raul Oscar Elias, 'Legal aspects of swaps and collateral' (2001) 3(6) Journal of International Financial Markets p. 232

9 Steven Edwards, 'Legal principles of derivatives' (2002) Jan Journal of Business Law p. 1

10 Rodrigo Zepeda, 'The ISDA Master Agreement 2012: A missed opportunity' (2013) 28(8) Journal of International Banking Law and Regulation p. 308, p. 310

11 See section 1.2.1.3

12 This is, however, addressed by the membership requirements ensuring that the exchange members are well-capitalised and have risk management procedures in place

13 Another important type of credit risk mitigation is constituted by guarantees, whereby a parent or third party undertakes to honour obligations incurred with a certain transaction. Such guarantees are commonly used by investment funds or financial institutions outside of Europe, and will therefore not be further discussed

14 Another credit risk mitigation technique is the provision of a guarantee by a parent or third entity for a trading vehicle, which is mostly used outside of Europe or by non-financial institutions, and will therefore not be further discussed in this thesis

regulators traditionally promoted these credit risk mitigation techniques and financial contracts. The central legal element promoting their useis the protection against otherwise mandatory insolvency law provisions, provided the financial contracts and the related credit risk mitigation arrangements satisfy specific preconditions. In other words, credit risk mitigation techniques are valid and enforceable despite the commencement or continuation of an insolvency procedure or reorganisation measure. Since these techniques mitigate the risk related to financial contracts, they also reduce regulatory capital intended to absorb potential losses arising from the counterparty's default. Regulatory capital is, however, costly for financial institutions and economies of the states as it precludes a more economically useful avail of the encumbered assets. Empirical evidence regarding the efficacy of the regulatory capital is ambiguous.[15]

Collateral forms, in practice, part of such close-out netting arrangements.[16] It is a form of security whose value is ordinarily commensurate with the net obligation owed to the party with the greater notional value. This amount resembles the value that is liable to be lost as result of the counterparty's default. Ostensibly, close-out netting reduces the exposure and expected loss that could materialise from the default of counterparties. However, there are various academic challenges regarding the legitimacy and public policy justification.

Without close-out, there is a risk that only profitable transactions are ascertained by an insolvency practicioner administering the debtor, while disclaiming unprofitable transactions.[17] In effect, it reduces the non-defaulting party's exposure to the defaulting party to the net figure. The creditor would experience significant distress by having to perform its obligations while being unable to enforce related claims. This mitigation of credtis risks reduces the probability of subsequent defaults– thereby promoting financial stability; it thwarts the occurance of the so-called domino effect aso called interdependence risk.[18] Therefore, policymakers and regulators widely promote this mechanism as contributing to financial stability by mitigating the effects of a default. This promotion takes the form of a carve-out from the scope of otherwise compulsory suspensions and restrictions that apply in insolvency. Thus, it can operate notwithstanding any actual or impending insolvency proceeding or restructuring measures.

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15 Karim Pakravan, 'Bank capital: the case against Basel' (2014) 22(3) Journal of Financial Regulation and Compliance p. 208; Alexander Zimper, 'The minimal confidence levels of Basel capital regulation' (2014) 15(2) Journal of Banking Regulation p. 129; Ari Kurniawan and Ioannis Kokkoris. 'Will Basel III help to prevent a future crisis?' (2016) Nov Financial Regulation International p. 5; Avinash Persaud, 'Have post-crisis financial reforms crimped market liquidity?' (2017) 32(1) Journal of International Banking & Financial Law p. 3

16 Stephanie Loizou, 'The new Margin Rules: an overview' (2017) 32(2) Journal of International Banking Law and Regulation p. 67

17 That power is commonly referred to as "cherry-picking right" of the insolvency administrator, see Stephanie Loizou, 'Close-out netting and an introduction to the UNIDROIT principles on its enforceability' (2012) 27(10) Journal of International Banking Law and Regulation p. 429; Gerry Kounadis, 'Striking the correct balance between imposing a suspension of close-out netting rights while preserving legal certainty and market integrity in view of the Bank Recovery and Resolution Directive 2014/59/EU: Part A' (2015) 30(4) Journal of International Banking Law and Regulation p. 228 and Gerry Kounadis, 'Striking the correct balance between imposing a suspension of close-out netting rights while preserving legal certainty and market integrity in view of the Bank Recovery and Resolution Directive 2014/59: Part B' (2015) 30(5) Journal of International Banking Law and Regulation p. 276

18 See Miguel Virgos and Francisco Garcimartín, *The European Insolvency Regulation: Law and Practice* (Wolters Kluwer, 2004)

Financial institutions can reflect their exposure on a net basis. Close-out netting thereby ensures that the potential loss will never exceed the net figure. However, close-out netting does not entail payment. Close-out netting does not dispense with the creditors obligations under insolvency law to recover the net amount. Creditors benefiting from close-out netting must prove their claims like any other creditors in insolvency. And recovery depends on the relative priority in the creditor hierarchy. Close-out netting is therefore often combined with security in the form of collateral whose value can be realised to discharge the net amount.

Critics claim that close-out netting undermines the objectives of insolvency, is prejudicial to the general body of creditors and is, in fact, detrimental to financial stability. A fallacy found in literature, and sometimes also shared by regulators and legislators, is that financial contracts caused or significantly contributed to the financial crisis of 2007. However, there is now evidence corroborating such claim[19] In accordance with their contractual rights, parties sought to terminate their relationships with failing financial institutions as soon as possible, thereby causing payment obligations and appropriating assets producing a result akin to a bank run. The effect was that authorities were unable to intervene and to rehabilitate the affected financial institutions to enable them to continue operating as going concern. This position seems irreconcilable with the presumed beneficial effects of close-out netting. Not surprisingly, the voices that seek to abolish the carve-outs of derivatives and their framework agreements became louder.

The financial crisis has reinvigorated the criticism of credit risk mitigation techniques and has cast a bleak shadow over financial contracts.[20] During the crises, it transpired that credit risk mitigation techniques could exacerbate the distress of financial institutions and frustrate their rehabilitation as well as depress asset values and cause the failure of connected institutions. Another popular criticism is that certain financial contracts have created perverse incentives and have promoted the clandestine creation and accumulation of risk. Inevitably, the development adversely affected the financial system, thereby aggravating the ramifications of the financial crisis of 2007 if not even causing it. While this criticism comprehensively challenges the support for close-out netting, it is

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19 See section 4.3

20 See section 2.3 and Franklin Edwards and Edward Morrison, 'Derivatives and the Bankruptcy Code: Why the Special Treatment?' (2005) 22 Yale Journal on Regulation p. 91, p. 101; Stephen Lubben, 'Repeal the Safe Harbors' (2010) 18 American Bankruptcy Institute Law Review p. 319, p. 334; Mark Roe, 'The Derivatives Market's Payment Priorities as Financial Crisis Accelerator' (2011) 63 Stanford Law Review p. 539, p. 587; David Skeel, 'Bankruptcy Boundary Games' (2009) 4 Brooklyn Journal of Corporate, Financial and Commercial Law p. 1, p. 19; David Skeel and Thomas Jackson, 'Transaction Consistency and the New Finance in Bankruptcy' (2012) 112 Columbia Law Review p. 152, p. 187; Robert Bliss and George Kaufman, 'Derivatives and systemic risk: Netting, collateral, and closeout' (2005) Federal Reserve Bank of Chicago WP 2005-03; Stephen Lubben, 'The bankruptcy code without safe harbors' (2010) 84 American Bankruptcy Law Journal p. 123; Mark Roe, 'The derivatives market's payment priorities as financial crisis accelerator' (2011) 63 Stanford Law Review p. 539; David Skeel, Jr and Thomas Jackson, 'Transaction consistency and the new finance in bankruptcy' (2012) 112 Columbia Law Review p. 152; Edward Janger, 'Arbitraging systemic risk: system definition, risk definition, systemic interaction, and the problem of asymmetric treatment' (2014) 92 Texas Law Review; Edward Morrison, Mark Roe and Christopher Sontchi, 'Rolling back the repo safe harbors' (2014) 69 Business Lawyer 1015; Steven Schwarcz and Ori Sharon, 'The bankruptcy law safe harbor for derivatives: A path dependence analysis' (2014) 71 Washington and Lee Law Review p. 1715; Steven Schwarcz, 'Derivatives and collateral: Balancing remedies and systemic risk' (2015) 2015(2) University of Illinois Law Review p. 699 and Adam Levitin, 'Prioritization and Mutualization: Clearinghouses and the redundancy of the bankruptcy safe harbors' (2015) 10(1) Brooklyn Journal of Corporate, Financial & Commercial Law p. 9 p. 129

submitted that the source of these conjectures is the failure to fully appreciate the inherent risks and benefits described below. One of these is the notion of systemic risk, a notion that gained significant momentum during the financial crisis of 2007.[21] It means a material impediment to the provision of crucial financial functions with negative implications for the "real" economy. Financial stability was perceived is an ultimate goal of financial regulation, also justifying prohibition and intervention in private law and rights. Yet, an exhausitive definition of financial stability is elusive.[22] Consequently, if not used cautiously, this wide notion may serve as a unreasonable auspice for new legislation and regulation. The falsely acclaimed conjectures about financial contracts and credit risk mitigation and their interactions with financial stability were at the centre of the discussions.

Another argument is that since credit risk mitigation techniques reduce credit risk incurred with financial contracts, this risk reduction creates adverse incentives, such as less scrutiny in the selection of counterparties and monitoring. However, this is a failure to distinguish between or balance the necessity for prudential and conduct regulation.[23] Reduction of the enforceability of credit risk mitigation techniques to regulate conduct is an untargeted approach. Not only does it contribute to risk, it also negates the benefits of risk mitigation and financial contracts themselves to its users and the economy at large. Overall, even under the assumption that these arguments were valid, banking and capital market regulation may hold more promising measures without negating the benefits of close-out netting and financial contracts (as will be see below).

Moreover, this argument is often conflated with discussion concerning close-out netting's propensity to deprive the debtor and the general body of creditors of assets or rights that would have been otherwise available. Undoubtedly, insolvency law plays a crucial role in the economy, and its application is therefore mandatory and in most cases overriding. However, in contrast to the existing academic discurse, the following sections and in particular section 2.4 below examine insolvency law to discern and conclude that, under English law, close-out netting is consistent with the policy rationale and letter of insolvency law, jurisprudence and case law.

An often overemphasised and misunderstood argument is that financial contracts considerably shape the risk profile of financial institutions. Although financial contracts can be used for proprietary trading,[24] they can simultaneously be used to reduce proprietary risk and the risk posed by clients.

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21 An exhaustive definition is elusive. See section 4.3.2.1

2222 It may be better to take a more granular approach to detect known symptoms, such as depressed asset values, illiquidity or problems to raise liquidity, unsustainable debt for a prolonged period of time in certain industries or regions, see Carmen Reinhart and Kenneth Rogoff, *This Time is Different: Eight Centuroes of Financial Folly* (1st edn, Princeton University Press 2009)

23 In England, the former is supervised by the Financial Conduct Authority and the letter by the Prudential Regulatory Authority

24 Proprietary trading as defined in JP Morgan Chase Bank and others v Springwell Navigation Corporation [2005] EWHC 383: "There was a distinction between the market-making book and the proprietary book. The market-making book was comprised of short term positions operated by the flow traders for the purpose of making a market. The proprietary book was different. Chase as an institution also made investments on its own behalf and this included investment in emerging markets debt. The proprietary traders were entirely separate from the flow traders and from the salesmen. They purchased and sold investments on Chase's behalf, in the pursuit of whatever long term or other strategy had been determined by those responsible for Chase's own investment management". The taking of an open position is the same as investing for instance directly in shares; however, it facilitates the execution of the investment strategy and the leveraging of the investment. While this leveraging of risks if mismanaged may result in greater losses, it can achieve greater profits. It explains why financial

Thus, contrary to common belief, the "shaping" does not necessarily imply creation, but rather and most importantly, mitigation of risk. Moreover, financial contracts are fundamental to the liquidity management of financial institutions. That is the most prominent link between financial contracts and stability.[25]

1.2 Financial contracts

The term "financial contracts" in this thesis encompasses both derivatives and securities financing transactions, which are discussed further below. The objective of such financial contracts may be the allocation and redistribution of risks incurred in the course of the entities' ordinary operations.

1.2.1 Financial derivatives

Despite their sizeable amount, there is no globally accepted and comprehensive definition of the term "financial derivatives".[26] The most basic definition is as follows: financial derivatives are contracts whose value is, amongst others, dependent on the development of a reference value.[27] There are virtually no limitations to the reference value, which can be ordinary market values such as financial securities, indices, rates, commodities; default risk, amongst others of other market participants or loans; and climate data, inflation rates and other derivatives all of which can serve a legitimate purpose.[28] A comprehensive legal definition is elusive because financial innovation continually creates new forms of financial derivatives so as to meet evolving market needs.[29] Therefore, a static legal definition is unsuitable. In fact, neither European nor English law offer a comprehensive legal definition of the term "financial derivative". The respective legislation refers to a myriad of contracts and reference values.[30] A functional approach is to consider common components.[31] The following definition was provided by Simon Firth

> … transaction under which the future obligations of one or more of the parties are linked in some specified way to another asset or index, whether involving the delivery of the asset or the payment of an amount calculated by reference to its value or the value of the index. The transaction is therefore treated as having a value which is separate (although derived) from the values of the underlying asset

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institutions maintain strict policies and controls in relation to new transactions, requiring senior level approval of the relevant credit, risk and legal departments"

25 Philipp Paech, 'Repo and derivatives portfolios between insolvency and regulation' (2017) LSE Law, Society and Economy Working Papers 13/2017

26 Alastair Hudson, The Law on Financial Derivatives, (4th edn, Sweet & Maxwell 2006) p. 13

27 See John-Peter Castagnino, *Derivatives: The Key Principles* (2nd edn, Richmond Law & Tax 2004) p. 1 and Schuyler Henderson, *Henderson on Derivatives* (Suffolk, Reed Elsevier Ltd, 2003), p. 3; Alastair Hudson, *The Law on Financial Derivatives* (5th edn, Sweet & Maxwell 2012) p. 25. A common misconception of derivatives is that they derive their value only from the value of the underlying, see e.g. Florian Fuchs, *Close-Out Netting, Collateral und Systemisches Risiko: Rechtsansätze zur Minderung der Systemgefahr im Außerbörslichen Derivatehandel* (Mohr Siebeck 2013) p. 10, Bryan Faubus, 'Narrowing the Bankruptcy Safe Harbor for Derivatives to Combat Systemic Risk' (2010) 59 Duke Law Journal p. 801, p. 809, and Alastair Hudson, *The Law of Finance* (1st edn, Sweet & Maxwell 2009) p. 1089

28 Joanna Benjamin, *Financial Law* (Oxford University Press 2008) paras 4.30 et seq.

29 Philip Wood, *Set-Off and Netting, Derivatives, Clearing Systems* (2nd edn, Sweet & Maxwell 2007) para. 82 and Philip Wood, The Law and Practice of International Finance (Sweet & Maxwell 2009) p. 425. Also, Hudson described financial derivative as a term 'not capable of a precise definition', see Alastair Hudson, *The Law of Finance* (1st edn, Sweet & Maxwell) p. 1089

30 English Law refers to Directive 2014/65/EU (Markets in Financial Instruments Directive, "MiFID")

31 Barbara Grunewald and Michael Schlitt, *Einführung in das Kapitalmarktrecht* (2nd edn, C.H. Beck 2009) 125; a seminal paper on the role of financial innovation for improved risk management is Robert Merton, 'Financial Innovation and the Management and Regulation of Financial Institutions' (1995) 19(3-4) Journal of Banking and Finance p. 461

> or index. As a result, the parties' rights and obligations under the transaction can be treated as if they constituted a separate asset and are typically traded accordingly.

Hedging and speculation are amongst the various reasons why private and public bodies seek to enter into derivatives.[32] Whereas hedging involves the intention to reduce risk by transferring it to the counterparty, speculation refers to intentional exposure to a volatile asset or other economic values for profit. Due to this notion of risk and the connotation of speculation, regulators have generally advocated the need to curb speculation.[33]. Even though some entities seek only to hedge their risk, a clear demarcation between hedging and speculating is impossible. A perfect hedge is rarely possible. A mismatch between the hedge and the related risk constitutes a propriateray transaction which can amount to speculation.[34] Additionally, to conclude a hedge transaction, the counterparty needs to be prepared to take the opposite position, thereby accepting the risk. It follows intuitively that hedging is impossible without speculation by the other party. These opposite positions may also arise because the parties formed different expectations about some future event or are more apt to distribute the risk, whereby the premium offsets the possible loss.

1.2.1.1 OTC derivatives

Bespoke over-the-counter ("OTC") derivatives have often been connotated with the notions of complexity and latent risk.[35] Since there is no transparent market that matches supply and demand through a continuous quotation of prices, their nature is understandably considered somewhat opaque. This belief is reinforced by their bespoke character, whereby the structuring of the products varies drastically. This perception seems to be corroborated by the exotic pricing methodologies; various variables, viz. strike price,[36] barriers, tenor and volatility as well as the various assumptions, viz. riskless interest rate, and expected dividends or coupons of the underlying.[37] Before the financial crisis of 2007, such transactions where concluded almost exclusively outside the purview of the regulators. During the crisis, the propensity to foster interconnection[38] and facilitate aggregations of risks surfaced. To monitor any accumulation of risk but also to mitigate ramifications arising from failures of a financial institution, the global regulatory reform envisaged interposing individual institutions that are subject to heightened regulatory and risk management requirements, so-called central counterparties ("CCPs"). These entities consequently become the buyer to every seller and seller to every buyer. If one party defaults, the CCP guarantees to honour the obligations of the defaulting counterparty, thereby preventing that interdependent default ensue.

Whereas bespoke OTC derivatives allow counterparties to tailor the transaction to accommodate their needs, exchange-traded derivatives are highly standardised. It implies that structuring the transaction to the economic needs is impossible. For instance, if a party seeks to hedge a loan

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32 See *Lomas v JFB Firth Rixson Inc* [2012] EWCA Civ 419 at 2

33 Colin Scott and John Biggins, 'Public-private relations in a transnational private regulatory regime: ISDA, the state and OTC derivatives market reform' (2012) 13(3) European Business Organization Law Review p. 311, pp. 342 sq and Dan Awrey, 'The dynamics of OTC derivatives regulation: bridging the public-private divide' (2010) European Business Organization Law Review p. 156, pp. 173 sq

34 As a consequence, regulation usually considers only the beginning of a transaction to discover whether parties sought to use it as hedge or investment.

35 Alastair Hudson, *The Law on Financial Derivatives* (6th edn, Sweet & Maxwell 2017) Part C

36 It means the price at which the derivative (usually an option) can be exercised

37 For instance dividends if the underlying is a share

38 See section 4.3.2

against foreign exchange risk, it must identify the following: first, the foreign exchange futures in the relevant currency pair must cover, alone or in aggregate, the necessary notional value. Second, it must be ensured that the futures mature at the same time or later than the loan. The survivng hedge not only fails to hedge exposure but create it. However, if the currency pair involves an unusual combination or an uncommon currency, the exchange may not provide a suitable future, such that it would be necessary to enter into an OTC derivative. For instance, pension funds and insurance companies incur complex risks in the ordinary course of business that require bespoke solutions.

While having an extensive history, the volume of OTC derivatives grew only over the recent three decades.[39] Trades in the OTC realm gained importance with the nascence of, amongst others, swaps in the 1980s.[40] Characteristic of this period was the tedious and, at times, onerous documentation liable to failure and legal challenge. As a response, the International Swaps and Derivatives Association, Inc. ("ISDA") was established in 1985. Its primary aim was to standardise practice and documentation with the ultimate objective of promoting legal certainty while reducing costs.[41] ISDA presiding in the realm of financial derivatives prepared a framework agreement governing the relationship between two parties. This agreement allows parties to conclude various transactions. Such a framework promotes certainty amongst its users. The chief consideration is the management of default and allocation of costs. The framework also envisages the consequences of a default of one of the counterparties. The importance of the master agreements has been subject to numerous critical discussions.[42] It follows from the law-like characteristics in the transnational context, which is compared to some form of *lex mercantoria* that operates outside the common legal framework.[43] The above discussion illustrates that legal documentation via master agreements prepared by trade associations attempts to optimise the use of financial contracts and reduce overall risk. Master agreements do not operate outside the law. As will seen that they master agreements rely on principles of English law and that their application is adjusted so as to meet the requirements of today's financial markets. For this purpose, certain concepts are used that ensure the proper

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39 See Rodrigo Zepeda, 'The ISDA Master Agreement 2012: a missed opportunity?' (2013) 28(8) Journal of International Banking Law and Regulation p. 308

40 See Tony Shea, 'The usefulness of netting agreements' (1991) 6(4) Journal of International Banking Law p. 132 and Michael Potter, 'Swaps: 1992 ISDA master agreements' (1993) 11(11) International Banking and Financial Law p. 125

41 Practice was harmonised by introducing the Swap Codes of 1986 and 1987. Documentation in the form of a template was introduced by the 1987 Swap Agreement. See Paul Harding, *Mastering the ISDA Master Agreements (1992 and 2002)* (Financial Time Prentice Hall) p. 19

42 See Maciej Borowicz, 'Private Power and International Law: The International Swaps and Derivatives Association' (2015) 8(1) European Journal of Legal Studies p. 46, Dan Awrey, 'The Dynamics of OTC Derivatives Regulation: Bridging the Public-Private Divide' (2010) 11(2) European Business Organization Law Review p. 155 and John Biggins and Colin Scott, 'Public-Private Relations in a Transnational Private Regulatory Regime: ISDA, the State and OTC Derivatives Market Reform' 13(2) European Business Organization Law Review p. 309

43 Hugh Collins, 'Flipping Wreck: Lex Mercatoria on the Shoals of Ius Cogens' in Stefan Grundmann, Florian Möslein and Karl Riesenhuber (eds) *Contract Governance: Dimensions in Law and Interdisciplinary Research* (Oxford University Press 2015) 383; Horst Eidenmüller, 'Lex Mercatoria, the ISDA Master Agreement, and Ius Cogens: Comment on Hugh Collins, "Flipping Wreck: Lex Mercatoria on the Shoals of Ius Cogens"' in Stefan Grundmann, Florian Möslein and Karl Riesenhuber, Ibid, p. 407; Roy Goode, Herbert Kronke, and Ewan McKendrick (eds) *Transnational Commercial Law: Texts, Cases and Materials* (2nd edn, Oxford University Press 2015) paras 1.04, 1.56 and 1.63 sq; Francisco Garcimartin and Maria Saez, 'Set-off, Netting, and Close-out Netting' in Matthias Haentjens and Bob Wessels (eds) *Research Handbook on Crisis Management in the Banking Sector* (Edward Elgar 2015) p. 331 at paras 14.3.1–2

construction of master agreements and of close-out netting and collateral arrangements by courts, which are explained below.

The framework documenting derivatives and collateral is commonly referred to as ISDA documentation architecture. Under the architecture, the master agreement,[44] schedules to the master agreement, confirmations and credit support documents constitute the crucial layers of documentation. Whereas the master agreement - an umbrella document containing boilerplate provisions - cannot be altered, the schedules provide for the possibility to amend the agreement so as to suit the parties' requirements. Confirmations allow specifying the economic terms of every single transaction concluded under a master agreement.[45] Confirmations incorporate product-specific definitions set out in booklets.[46]

On 8 January 1993, ISDA published its first master agreement, known as the 1992 ISDA Master Agreement.[47] Due to shortcomings that emerged during the 1997 Asian and 1998 Russian debt crises and the related prominent defaults of Long-Term Capital Management and Peregrine Investments Holdings Ltd,[48] ISDA revised the 1992 agreement. In particular, it identified gaps in the calculation of the close-out amount, grace periods and close-out notifications, which it thought to remediate in the master agreement of 2002.[49] A novel feature of the 1992 and 2002 ISDA Master Agreements provided by ISDA, is its ability to combine a series of transactions documented with various confirmations. This mechanism is known as the "single agreement" concept and is set out in section 1(c) of the master agreement. It allows parties to enter into new transactions in reliance that the existing transactions will be honoured and that, upon default, all transactions can be replaced by a single net amount – since the transactions were deemed to constitute a single transaction at any point in time. This early termination upon the occurrence of an event of default in accordance with section 2(c) of the master agreement.[50] For events of default deemed severe, such as failure to pay or deliver. If unsuccessful, close-out netting is applied.

Parties cannot use a confirmation alone without an umbrella agreement governing the legal relationship. However, business requirements may demand that a transaction is concluded swiftly, and the negotiation of a master agreement can pose a significant obstacle. Thus, there is an

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44 Although certain market participants still trade with old master agreements, the most commonly used agreements take the form of the 1992 ISDA Master Agreement (multicurrency, cross-border form) and 2002 ISDA Master Agreement (multicurrency, cross-border form)

45 Individual transaction terms include, for instance, the type of derivative, the role of each counterparty, e.g. which counterparty represents the fixed rate payer or a floating rate payer in a swap transactions, the start date and term of the trade , payment conventions, particularly where the transaction is cross-border or in a foreign currency (such as the settlement currency), and other additional provisions specific to that trade, see *Bankers Trust International Plc v PT Dharmala Sakti Sejahtera* [1990] 2 All ER 1024.

46 These booklets are commonly called the ISDA definitions

47 See Rodrigo Zepeda, 'The ISDA Master Agreement 2012: a missed opportunity?' (2013) 28(8) Journal of International Banking Law and Regulation p. 308

48 See Paul Harding, *Mastering the ISDA Master Agreements (1992 and 2002)* (Financial Time Prentice Hall) p. 139

49 Although the 2002 agreement addresses various of the weaknesses of the 1992 Master Agreement, the latter remains widely used. Any differences can be addressed by adhering to protocols, which modify selected parts of the master agreement as long as both parties adhere. Thus, many master agreements predating the 2002 agreement remain in force, in amended form

50 These are (i) failure to pay or deliver, (ii) breach of agreement, (iii) credit support default, (iv) misrepresentation, (v) default under specified transactions, (vi) cross default, (vii) bankruptcy and (viii) merger without assumption, see section 5(a) of the 1992 ISDA Master Agreement

alternative architecture in the form of a long-form confirmation:[51] The counterparties agree to sign a master agreement and, in the interim, the signed confirmation constitutes a complete and binding agreement and shall be governed by a master agreement as designated in the confirmation – without any schedules and specifications but for the governing law and termination currency.[52] ASuch long-form confirmations are also used to document short-lived or one-off transactions which would not merit the onerous negotiation of a master agreement.

Two categories result in early termination of transactions. ISDA Master Agreements distinguish between events of default[53] and termination events.[54] Whereas the former is a preventive measure due to counterparty-specific developments that indicate imminent distress, the latter can be invoked upon the occurrence of certain external events, such as regulatory or taxation amendments, which impede the continuation of a transaction. The non-defaulting counterparty triggers close-out netting arrangements by designating an early termination date by notice or automatically upon the occurrence of an event of default. The principle of private autonomy protects the right to freely negotiate and conclude contracts.[55] Hence, as a general principle, before the commencement of insolvency proceedings parties may agree that upon the occurrence of specific events their contracts will terminate. And it is accepted in English law that termination upon the commencement of an insolvency proceeding or introduction of restructuring measures is valid unless there overriding policy grounds[56] or if such termination is contradictory to mandatory law as will be discussed below.[57]

(a) Single agreement provisions

The single agreement provision reinforces the conjecture that all claims and obligations form a single liability as of the inception of the trading relationship.[58] In England, courts have been willing to uphold this concept. The underpinning rationale is that transactions are interdependent, viz. the conclusion of new transactions is premised on the reliance that existing transactions are honoured and that the affirming of individual transactions and disaffirming of others by an insolvency practitioner would be "unfair". That also applies to the non-defaulting party by implication, such that it cannot just terminate positive transactions. The meaning of interdependent or interlinked is uncertain. Combining transactions that are of a different economic nature, i.e. equity and debt instruments, may risk being unenforceable due to abuse of exemption.

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51 See Exhibit I to the 2006 ISDA Definitions

52 See *LSREF III Wight Limited v Millvalley Limited* [2016] EWHC 466 (Comm), see also Rajesh Pillai and Hannah Glover, 'ISDA Master Agreement: Party choice versus non-derogable state law' (2016) Journal of International Banking and Financial Law p. 401

53 Section 6(a) of the Master Agreements

54 Section 6(b) of the Master Agreements. A distinctive feature of close-out netting is that it is invoked in anticipation of or due to a default. Other forms of netting include payment netting, i.e. the aggregation of payments to be made on the same date and in the same currency

55 Schuyler Henderson, 'The New Regime for OTC Derivatives: Central Counterparties Part 1' (2011) 26(4) Journal of International Banking and Financial Law p. 2

56 See section 2.4.3.1

57 For instance, essential supplies are protected under sections 233 and 233A of the Insolvency Act 1986; and see sections 2.4.3.2 to 2.4.3.4

58 See Simon Firth, Derivatives: Law and Practice (Sweet & Maxwell 2012), para. 5-23

(b) Flawed asset provisions

The flawed asset provision stipulates that the satisfaction of future obligations is conditional upon absence of a failure to perform by the other party.[59] It is permissible to rescind or suspend all obligations upon the counterparty's default.[60] The rationale is that it reduces exposure to a defaulting counterparty. The case of Lehman Firth Rixson illustrates the importance and policy motivation to underpin the flawed asset provision. On 15 September 2008, Lehman Brothers went into administration, which constituted an event of default under all relevant master agreements. Given that all of Firth Rixson's transactions were out-of-the-money, the close-out netting rights were not exercised– and all obligations were suspended by relying on the flawed asset provision.

The administrator challenged Firth Rixson's decision to cease making payments. He submitted that the literal construction of section 2(a)(iii) was not commercially reasonable or sensible.[61] Firstly, he stated that first, it could be implied that the notification should be submitted within a "reasonable period" of time. Second, it could be implied that the flawed asset provision should come to an end by way of "effluxion of time", i.e. resulting from the maturity of the last transaction under the master agreement. Failure to recognise either of the above would offend the anti-deprivation principle, whereby contractual arrangements that deprive the general body of creditors are rendered void. The administrator claimed that the non-defaulting party must exercise its rights in a manner not "arbitrary, capricious or unreasonable".[62]

At first instance, Briggs J rejected Lomas's submissions. He agreed with Firth Rixson who submitted that the failure to cure the event of default during the lifetime of the transaction would lead to a permanent suspension of payments. Moreover, he held that the permanent suspension was neither contrary to nor offended the anti-deprivation principle. This position was upheld by the Court of Appeal, which added that the last payment date was irrelevant for the determination of the flawed asset, thereby accepting ISDA's position.

However, during proceedings, the question of insolvency set-off under the predecessor of the rr 14.24 and 14.25 of the Insolvency Rules 2016 was never raised. Given the administrator's notice issued on 4 December 2009, insolvency set-off should have been invoked. Thereby, the administrator would have avoided the discussion on the proper construction of the flawed asset provision. The rule stipulates that, once a distribution notice is issued, "an account shall be taken as at the date of the notice… of what is due from the other".[63] A possible explanation is that close-out

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59 The good definition can be found in *Oditah* [1992] 108 LQR 459: "A property or right subject to removal in the event of insolvency"

60 See *Shiption Anderson & Co v Micks Lamber* (1936) 2 All ER 1032

61 See Robin Parson, 'Firth Rixson: Why didn't mandatory set-off apply?' (2011) 11 Journal of International Banking and Financial Law p. 663, Mark Daley, 'Defining the limits of s 2(a)(iii)' (2009) 11 Journal of International Banking and Financial Law p. 647 and Glen Davis, 'Firth Rixson in the Court of Appeal' (2012) 6 Journal of International Banking and Financial Law p. 337; on this issue see also more recently Catherine Gurney, 'Calling Time on section 2(a)(iii) of the ISDA Master Agreement: ISDA Publishes an Amendment' (2014) 29(8) Journal of International Banking and Financial Law p. 520 and Ed Nalbantian and Liz Saxton, 'section 2(a)(iii) of the ISDA Master Agreement: a brief retrospective' (2014) 29(3) Journal of International Banking and Financial Law p. 195

62 See Edward Murray, 'Lomas v Firth Rixson: 'As you were!' (2013) 8(4) Capital Markets Law Journal p. 395

63 See Geoffrey Yoewart and Robin Parsons, *Yoewart and Parsons on the Law of Financial* Collateral (Elgar Financial Law and Practice 2016) p. 237

netting could be prejudicial for the debtor, e.g. if causing a payment obligation. However, Lehman Brothers was in-the-money on all transactions on 4 December 2009, and future payments could have been taken into full account when setting off the transactions.

Yoewart and Parsons suggest that the court would reject a position that would allow a non-defaulting party to enforce its claims without regard to its obligations.[64] In other words, the parties must give due regard to the other's credit.[65] But even if the flawed asset provision contravened the anti-deprivation principle, the master agreement could be partially enforced, rendering void only the offending provision. This suggests that "flawed asset" is an application of the set-off principle. The flawed asset provision serves as a second flanking point to stress that the counterparties make the continuance of their trading relationship contingent on the satisfaction of due and payable or deliverable obligations. Hence, if one party does not honour its obligation, the counterparty may suspend performance of its reciprocal obligations.[66] The obligation does not cease to exist. The suspension is lifted if the default is "cured", e.g. if the failed payment or delivery has been executed or if the non-defaulting counterparty invokes the right to set off. [67] This suspension has been criticised in recent decisions and critical literature.[68] To the effect that there is no reasonable probability for the defaulting party to cure the default and the non-defaulting party is out-of-the-money, the latter will not invoke its right. It can result in a permanent suspension of the non-defaulting party's obligation, thereby depriving the defaulting counterparty of its payment.

A permanent suspension seems disproportionate given the availability of set-off.[69] Set-off arrangements, in contrast to flawed asset provisions, can ensure that the defaulting party is treated fairly. Permanent suspension resembles a penalising walk-away provision, whereby upon default, the non-defaulting counterparty can terminate its relationship with the defaulting party without discharging its due obligations. The former thus risks offending the anti-deprivation principle.[70] However, this rhetoric fails to recognise that the time-bar is set in accordance with r 14.24 and r 14.25 of the Insolvency Rules 2016.

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64 See Geoffrey Yoewart and Robin Parsons, *Yoewart and Parsons on the Law of Financial* Collateral (Elgar Financial Law and Practice 2016) p. 240. Briggs J submitted: "I might have concluded that if section 2(a)(iii) operated so as to increase LBIE's obligation on any future payment date from a net amount (after giving credit for the fixed rate amount due from the counterparty) to a gross amount, namely the whole of the floating rate amount, that might well have offended the anti-deprivation principle, for the simple reason that it imposed a greater financial obligation on LBIE in favour of a particular creditor by reason of LBIE's insolvency, than would otherwise have been imposed", see [Lehman Firth Rixson, first instance judgement, para [115]]

65 In Belmont, Lord Collins found that flawed asset provisions do not offend the anti-deprivation principle if the arrangement is a *bona fide* one. He found that since the flawed asset is commercially sensible and does not seek to deprive the counterparty of any assets, since it can apply to either party depending on who enters into dissolution, the flawed asset provision is indeed a *bona fide* arrangement. Deprivation of the counterparty or the estate is not of concern

66 Section 2(a)(iii) of the ISDA MA

67 See *Lomas v JFB Firth Rixson Inc* [2012] EWCA Civ 419 at [35], [62]

68 Ibid and Carl Baker, 'Rethinking the ISDA flawed asset' (2012) 27 Journal of Banking Law and Regulation p. 250

69 Louise Gullifer, *Goode on Legal Problems of Credit and Security* (5th edn, Sweet & Maxwell 2013), p. 297

70 The counsel for Lehman Brothers submitted this argument in *Lomas v JFB Firth Rixson Inc* [2012] EWCA Civ 419 at [35], [82]

(c) Events of default and termination

Close-out netting is invoked either automatically, i.e. without any procedural requirements, or upon the non-defaulting party serving a notice to the defaulting party setting out the terms of the termination. The rights are invoked upon the occurrence of a pre-defined event that might indicate that the continuation of the transactions is at risk, either because of material changes to the relevant legal and tax regimes or other significant outside forces, or because there are signs that the counterparty's creditworthiness is deteriorating. For instance, the inability to honour specified obligations which may not be part of the close-out netting arrangement, also known as cross-default, can be such an event of default.

The consequence executory contracts can be accelerated[71] or terminated[72] and be taken into consideration in the close-out amount. Given that executory contracts have an inherent value although not being due, Hobhouse submitted that[73]

> where there have been a whole succession of payments one way and the other in respect of a single underlying transaction, both equity and justice require that one should have regard to the totality of those payments and resultant overall benefit and detriment and not have regard to some arbitrary cut-off point…

In set-off, executory transactions are also deemed terminated upon the commencement of the insolvency proceeding, and become due.[74] As a principle of English contract law, parties may validly agree contractual terms which regulate the consequence of specific events. It includes the occurrence of insolvency and other defaults to the extent that it does not defeat the purpose of insolvency law.[75] Set-off would also recognise transactions that have been terminated and valued in accordance with the terms of its contract.

Valuation

Valuation aims to reflect the current market price for which the non-defaulting counterparty could enter into a replacement transaction. The terms of the contract are enforceable in accordance with general contract law. Thus, the valuation of terminated transactions is permissible in accordance with the terms of the contract, unless it constitutes enrichment, a penalty or similar. Since the terms of the securities financing transactions ("SFTs") predominantly calculate payments and interests due at default, the following discussion will concentrate on the derivatives which in contrast to SFTs do not have a market price.

The 1992 Master Agreement contains two valuation methods, namely 'market quotation' and 'loss'. While the former requires soliciting quotes for replacement transactions from leading institutions, the latter can only be invoked as a fall-back, in case the relevant party is unable to solicit quotes. Accordingly, the estimation of loss is more flexible. It enables the determining party, which is often

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71 Accelarition means to terminate a transaction outstanding obligations become immediately due and not on the initially envisaged future dates

72 Termination means that transaction are terminated and valued

73 Westdeutsche Landesbank Girozentrale v Islington LBC; Kleinwort Benson Ltd v Sandwell BC (aka Islington LBC v Westdeutsche Landesbank Girozentrale) [1994] 1 W.L.R. 938; [1994] 4 All E.R. 890

74 MS Fashions Ltd v Bank of Credit and Commerce International SA (No 2) [1993] Ch 425 per Hoffmann Justice (as he was then), see also Roy Goode, Principles of Corporate Insolvency Law (2nd edn, Sweet & Maxwell 1997) p. 195

75 However, consider section 2.4.2 for restrictions

the non-defaulting party, to estimate the total losses and gains in good faith.[76] In contrast, the 2002 Master Agreement only provides for calculation of the 'close-out amount'. It provides as in the case of loss, the determining party must calculate the replacement values in good faith. In a more elaborate fashion than the 1992 ISDA Master Agreement, the determining party is subject to using predetermined procedures that produce commercially reasonable results. It should be pointed out that valuation which exceeds the actual loss is deemed a penalty and can be challenged.[77]

1.2.1.2 Cleared derivatives

The post-crisis reform envisages that all standardised derivatives capable of clearing, shall be cleared. As mentioned earlier, clearing of derivatives refers to the interposition of a regulated entity between the transacting parties. This entity becomes the seller to the buyer and, conversely, buyer to the seller. Where one party defaults, it will continue honouring the obligations of the defaulting party. Due to heightened prudential measures and risk management requirements, it is believed that a CCP is more proficient in managing default than ordinary financial market participants. Parties musy adhere to the rules and conditions of the CCPs to clear. However, CCPs enter into bilateral agreements, the so-called break-glass agreements to manage own liquidity in case of severe stress or continue a transaction in case a clearing member defaults.

Clearing members are subject to the same rules and conditions and consequently identical terms. Since the agreement does not permit amending, inserting or deleting certain terms, all clearing members have the same rights. Like close-out netting provisions in the master agreements, rules contain "default rules" that regulate the default of the counterparty and employ set-off and netting as risk mitigation techniques and may even contemplate the consequences of the CCP's default. To become a clearing member, applicants must meet operational and financial criteria, such as minimum net capital.[78] Furthermore, the rulebook of CCPs provides for the technical processes involved in the clearing relationship, including default rules encompassing events of default and the default management method. Primarily, it also provides for the process of margining. If the CCP is owed a certain amount under a portfolio of derivative transactions, the margin equals the net amount of this portfolio. Essentially, variations in the mark-to-market values[79] of derivatives and thus of the portfolio on a net basis prompt margin calls. Margin calls for the benefit of the CCP represent security which offsets the risk of default of clearing members. In case a clearing member defaults, the value of the margin can be applied against the value of the defaulting clearing member's obligation. Accordingly, margin exchanged in favour of the clearing member offsets the risk of the default of the CCP.[80] Consequently, in principle, the exchange of margin should be sufficient to cover any

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76 See Andrew Savage and Leah Alpren-Waterman, 'Problems in pricing? Mastering market quotation under the 1992 ISDA Master Agreement' (2014) Journal of International Banking and Financial Law p. 636.

77 See section 2.4; it should be noted that the non-defaulting party has wide discretion, see *Lehman Brothers International EHF v Raiffeisen Bank International AG* [2018] EWCA Civ 719 and *Lehman Brothers International (Europe) v Exxonmobil Financial Services BV* [2016] EWHC 2699 (Comm)

78 See for example LCH.Clearnet's membership criteria. These criteria state, amongst others, that "LCH.Clearnet members are of a high credit quality and have large financial resources"

79 The amount that must be paid or is received if the contract is terminated early. It represents the replacement value of the affected transactions

80 There are two types of margin, namely variation and initial margin. The former covers the mark-to-market exposure, whereas the latter covers any potential amount that may arise between the last

exposure until close-out. That means that this exposure beyond close-out with the non-defaulting clearing member needs to be covered by additional sources.

The rulebook envisages various lines of defence to manage clearing members' defaults. These lines are often referred to as "default waterfall".[81] It encompasses the margin payments, dedicated resources set aside by the CCP,[82] and a mutualised loss fund,[83] which can be replenished with additional cash calls made to non-defaulting clearing members. Should the default fund contributions be insufficient, the rulebook envisages that the CCP may restructure the obligations to its clearing members by way of variation margin gain haircuts. As a last resort, some CCPs offer the possibility of contract tear-up. In other words, the rulebook addresses the materialisation of exogenous risk. Nevertheless, endogenous risk is in principle subject to ordinary insolvency law provisions. It may be submitted that the highest risk of internal failure is contingent on the occurrence of an extraordinary meltdown, testing the robustness of the clearing framework and rulebook.

1.2.1.3 Types of collateral

Credit support is the exchange security to discharge the counterparty's obligation in case of its default. Collateral can be exchanged by way of security interest[84] or title transfer.[85] Credit support documents can take the following three forms. The 2016 Variation Margin Credit Support Annex (Security Interest) and the 1994 ISDA Credit Support Annex, both governed by New York law, and the 2016 Phase One Initial Margin ("IM") Credit Support Deed and the1995 Credit Support Deed, governed by English law, envisage the exchange of collateral by way of security interest. Security interest means that the collateral taker merely has a charge for his benefit. Such characterisation is without problems under the laws of England and New York; however, when facing the laws of a third state, there is a considerable risk of recharacterisation, since the courts would seek to enforce the contract by applying their laws instead of the governing law of the contract. There are also potential limitations to the ability to substitute or realise collateral (if the Financial Collateral Directive does not apply[86]). In contrast, the 2016 ISDA Variation Margin Credit Support Annex (English transfer) and the 1995 ISDA Credit Support Annex governed by English law permit posting collateral by way of title transfer. Title transfer means that legal title is transferred from the collateral provider to the collateral taker. This mechanism is also referred to as outright transfer.

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exchange of variation margin and close-out. Furthermore, while variation margin constitutes purely cash and is adapted and exchanged on a daily or even inter-daily basis, initial margin can to some extent consist of highly liquid securities and is exchanged on a weekly basis

81 The default must be sufficient to enable the CCP to "withstand, under extreme but plausible market conditions, the default of the clearing member to which it has the largest exposures or of the second and third largest clearing members, if the sum of their exposures is larger", see Art 42(3) of EMIR. The principal requirements are stipulated in Art 45 of EMIR as expanded by Ch IX of Commission Delegated Regulation (EU) No 153/2013

82 Often referred to as *skin in the game*

83 Default fund contributions made by clearing members

84 Louise Guillifer, *Goode on Legal Problems of Credit and Security* (5th edn, Sweet & Maxwell 2013) pp. 11 et seq. Security interest requires searching the security register, perfection and compliance with other formalities anddoes not allow for the substitution of the interest without consent, thereby increasing the cost of the credit suport

85 See Louise Guillifer, *Goode on Legal Problems of Credit and Security* (5th edn, Sweet & Maxwell 2013) pp. 11 et seq and Joanna Benjamin, *Financial Law* (Oxford University Press 2008) pp. 305 et seq

86 See section 3.2

Moreover, the type of the credit support document has practical implications. First, the governing law of the ISDA master agreements and credit support documents rarely differ. While workable in a common law jurisdiction proficient in interpreting the terms of the ISDA master agreements and credit support documents, the rules of *dépeçage*[87] may lead to considerable uncertainty in third states. Second, the deed is a standalone instrument, whereas the annexes form part of the schedule to the ISDA master agreements. Hence, while the collateral arrangement under the annex forms part of the master agreement and thus of the close-out netting arrangement, the CSD's and NY law governed CSAs' value must be set off against the close-out netting amount.

Initial margin or independent amount[88] mitigates the risk that the variation margin may be insufficient to cover the whole exposure.[89] The margin period of risk describes the risk of collateral being insufficient to cover the new exposure due to an extended lapse of time between the last exchange of variation margin and close-out.[90] In other words, the independent amount or initial amount provides an additional cushion. A traditional reason for the limited use of independent amounts is the related transaction cost and risk. Overcollateralisation thus increases the credit risk for the collateral provider that in case of insolvency of the collateral taker, he may become an unsecured creditor in respect of the collateral amount posted in excess.

Before the financial crisis, it was common to trade on an unsecured basis with certain types of counterparty. The presumption was that the insolvency of the counterparty was a remote risk. Sovereigns or quasi-sovereigns and other well-capitalised financial institutions often benefited from this presumption. Unsurprisingly, after the financial crisis, this became unsubstantiated. As a consequence, evolving regulation on the clearing of derivatives prescribes the use of collateral also for OTC derivatives.[91]

1.2.2 Securities financing transactions

There are a variety of securities financing transactions. The term includes the lending or borrowing of securities and commodities. While there are various forms, the following discusses only repurchase agreements ("repos") and security lending agreements ("SLB"), since these are predominantly used by European financial institutions. Although repos and SLBs both have the title transfer of securities in common and have similar economic effects, there are substantial differences. In general, whereas repos manage the financial institution's liquidity by lending on a "secured" basis, securities lending agreements aim to facilitate investments but also the substitution of "bad" assets for high-quality assets to "alleviate" the balance sheet or pursue investment strategies. [92] There is

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87 Conflict of laws arising from a contract governed by more than two laws

88 Initial margin is documented under the ISDA 2016 Phase One Credit Support Annex for Initial Margin and the 2016 Phase One IM Credit Support Deed governed by NY and English law, respectively. The independent amount is exchanged as part of the 1994 and 1995 ISDA CSA, governed by NY and English law, repsectively

89 Initial amount is to be distinguished from initial margin. Initial amount is documented under the CSA and not as separate document

90 Art 272(9) of Regulation 575/2013 ("CRR"). See David Murphy, 'The rising risks and roles of financial collateral' (2014) Journal of International Banking and Financial Law p. 3

91 See Regulation 2016/2251 supplementing Regulation 648/2012 with regard to regulatory technical standards for risk mitigation techniques for OTC derivative contracts not cleared by a CCP

92 This will be further elaborated throughout this thesis. For a comprehensive overview see Financial Stability Board, *Interim report on securities lending and repos* (April 2012), Antony Bryceson, 'Lessons

also a fundamental difference in documentation and legal implications, which will be discussed below.

1.2.2.1 Repurchase agreements

There is no legal definition of repurchase agreements. Given the functional similarity, repos are often falsely described as secured loans. In legal terms, a repo transaction encompasses a sale between two parties with a simultaneous promise to repurchase the security or its equivalent, either debt or equity. Hence, instead of encumbering the security by way of security interest, charge or mortgage, the collateral taker is the buyer of the securities forming the collateral.[93] The reason behind this is that failure to qualify it as purchase and repurchase transaction has significant implications for their insolvency treatment, as will be seen below. In a repo transaction, the title to the security is transferred to the buyer by way of title transfer. The seller simultaneously enters into an obligation for the future repurchase of *equivalent security*[94] at a higher price. The price difference represents the repo rate, which is the equivalent of the interest on a loan. However, the sold collateral remains on the seller's balance sheet and any income such as dividends, coupon payments or other interest is treated as income for the seller.[95]

In contrast to a secured loan, a repo provides the buyer with greater comfort regarding the enforceability of his claim in case the seller defaults. The reason is that because upon the borrower's failure to repay the loan, the lender retains the securities, thereby discharging unpaid claims. There are no restrictions in realising and applying the value of the collateral. If the cash lender receives merely a security interest, he must make a claim, as a secured creditor, to the insolvency practitioner. The satisfaction of unsecured claims is uncertain for the following reasons. First, there is a period of uncertainty as to when the cash lender will receive his insolvency dividends. Second, there is uncertainty as to whether the security interest will be paid in full or partially because more senior claims may have exhausted the available assets.

Due to the title transfer, the cash buyer can sell the security to satisfy his claim under the contract. Otherwise, if he defaults, the lender can keep the monies received for the sale. Recharacterisation risk describes the risk of courts construing that the title transfer constitutes actual security interest.[96]

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from the Lehmans: the 2010 GMSLA and the short-selling regulation' (2010) 11 Journal of International Banking and Financial Law p. 667 and the websites of the trade associations SIFMA and ICMA for repos and ISLA for securities

93 Joanna Benjamin, Interests in securities, a proprietary analysis of the international securities markets (Oxford University Press 2000) para. 6.72

94 If the same security needs to be returned, courts could construe that the ownership never fully passed to the buyer. Consequently, there is a risk that the courts may recharactise the repo transaction as secured loan, see further below

95 *Innovatis Investment Fund Limited v Ejder Group Ltd* [2010] EWHC 1850 (Ch) per Norris J at para 30

96 Characterisation is described as "the process whereby the law decides whether a security interest or an absolute interest has been created by a particular transaction" (Hugh Beale, Michael Bridge, Louise Gullifer and Eva Lomnicka, *The Law of Security and Title Based Financing* (Oxford University Press 2012) paras 4-14). Determination of which rights and obligations are created by a contract comes within the inherent jurisdiction of the relevant courts – which is essentially a matter of interpretation and reconciliation with the legal principles (see similarly, Hugh Beale, Michael Bridge, Louise Gullifer and Eva Lomnicka, *The Law of Security and Title Based Financing* (Oxford University Press 2012) paras 4-16 and Joanna Benjamin, *Interests in securities* (Oxford University Press 2000) paras 6-66 which refer to recharacterisation as "a contractual matter"). Recharacterisation can be defined as "the process whereby the parties have characterised a transaction as creating one sort of interest and a court characterises that transaction as creating a different sort of interest" (Hugh Beale, Michael Bridge,

English courts have been typically inclined to give effect to the parties' intentions.[97] To underpin the intention of the parties and prevent recharacterisation, market participants developed safeguards that are contained in all master agreements.

The most frequently used master agreements in cross-border transactions are the (i) New York law-governed Master Repurchase Agreement ("MRA") published by the Bond Market Association and (ii) the English law-governed Global Master Repurchase Agreement ("GMRA") published by the International Capital Markets Association.[98] The GMRA is drafted without reference to national law other than its governing law and jurisdiction clause, whereas the MRA also contains New York law provisions[99]. It can be inferred that the GMRA was developed to operate on a cross-border basis – which also explains its more frequent use.[100]

The GMRA governs the legal and credit relationship between the parties. Like the master agreements governing financial derivatives and securities lending transactions, as discussed below, it consists of pre-printed standards text and annexes. The annexes allow the parties to make selections to mitigate risks and ensure enforceability of the master agreement. The master agreement and Annex I is generic to the extent that it applies equally to both parties. It also allows the parties to take reverse positions.[101]

Repos usually have a short tenor of three days or even overnight; however, it may also exceed 30 days. This depends on the jurisdiction and counterparties' preferences. Importantly, the GMRA provides for automatic roll-over, i.e. transactions are continued on identical terms unless one of the parties terminates. Parties can contractually fix net exposure. For this purpose, counterparties can agree on a "margin ratio", which is the prevalent (market) price at the time the securities were purchased divided by the purchase price. The margin required is calculated in accordance with the margin maintenance ratio.[102] This means that, depending on the fluctuations of the securities prices, additional margin may be called to reduce the exposure. The margin ratio must encompass all

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Louise Gullifer and Eva Lomnicka, *The Law of Security and Title Based Financing* (Oxford University Press 2012) paras 4-15). Characterisation is a judicial process divided into a construction and a legal categorisation stage, see *Agnew & Another v Commissioners of Inland Revenue* [2001] 2 AC 730, per Lord Milett, para 48. In the first stage, the court seeks to ascertain the relevant rights and obligations intended by the parties. The analysis also includes, besides the terms of the agreement, examination of the outcome of the transaction, see *Agnew* and In *Re Spectrum Plus Ltd (in liquidation)* [2005] 2 AC 680, per Lord Walker at 736. In the second stage, the court ascertains the substantive matter of the rights and obligations. Thus, courts consider the legal characteristic

97 Deviations from this general principle follow from using repos as sham devices. It occurs, for instance, where the parties do not intend a title transfer but a floating charge or a fixed charge. Consequently, a court needs to ascertain the substantive characteristics. See *Re Yorkshire Woolcombers Association Ltd* [1903] 2 Ch 284 CA and *Re Spectrum Plus Ltd (in liquidation)* [2005] 2 AC 680 and section 176A of the Insolvency Act 1986

98 There are national iterations which accommodate national law such as the French law-governed FBF Master Repurchase Agreement published by the Federation Bancaire Française or the German law-governed Deutscher Rahmenvertrag für Wertpapierpensionsgeschäfte (Repos) published by the Bankenverband

99 The MRA was primarily aimed to facilitate repos with US Treasuries and other agency securities

100 See Guidance Note prepared by the Securities Industry and Markets Association ("SIFMA") and the International Capital Markets Association ("ICMA") in March 2012

101 Apparently, what constitutes a repo for the collateral provider is a reverse-repo for the collateral taker, see Geoffrey Yoewart and Robin Parsons, *Yoewart and Parsons on the Law of Financial* Collateral (Elgar Financial Law and Practice 2016) p. 462

102 Para 4 of the GMRA

outstanding transactions.[103] Any exposure is eliminated by the adjustment of the price for which the securities must be repurchased.[104] For this purpose, the original transaction is terminated and simultaneously replaced with securities worth the initially agreed repurchase price. If an event of default occurs before the transaction matures, the non-defaulting party has the right to notify the defaulting party of its intention to terminate.[105] Parties to the transaction can also elect automatic early termination.

1.2.2.2 Securities lending agreements

The term "securities lending agreement" is a misnomer. These transactions do not provide for the lending of securities. As repos, security lending envisages title transfer.[106] As in the case of repos, the "borrower" must return equivalent securities upon termination of the transaction. Any value of the collateral exceeding the securities is referred to as margin. In contrast to repos, the collateral always takes the form of cash and its value is less than the securities.

Securities lending transactions have various functions, and the commercial premise differs from that underlying repos.[107] First, it allows the borrower to invest. Second, the borrower can use the securities lending transaction for liquidity purposes. Securities lending transactions can also take place within the a group. The Lehman inter-company repurchase agreements and stock loans ("RASCALS") case[108] concerning revealed this technique.[109] Intra-group repos replaced unsecured obligations of affiliates[110] to fund LBIE. LBIE used the proceeds to acquire securities outside the group. The repurchase was effected with a secured obligation of an affiliate. The true benefit was that LBIE could "lend" the securities to financial institutions outside the group virtually without any cost.[111] Lastly, securities lending transactions are used to "alleviate" the balance sheet. This process

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103 Alternatively, by mutual agreement, the parties can specify to adapt the price of the repo transaction and not the maintenance ration, see Geoffrey Yoewart and Robin Parsons, *Yoewart and Parsons on the Law of Financial* Collateral (Elgar Financial Law and Practice 2016) p. 463

104 Para 4(j) and 4(k)

105 See on the serving of default valuation notices and valuation of repos and securities lending transactions, *Lehman Brothers International EHF (in winding up) v Raiffeisen Zentralbank Österreich AG and Raiffeisen Bank International AG* [2017] EWHC 522 (Comm) and *Lehman Brothers International (Europe) v Exxonmobil Financial Services BV* [2016] EWHC 2699 (Comm)

106 *Forsta AP-Fomdem v BNY Mellon SA/NV and Ors* [2013] EWHC 3127 (Comm) at para 36

107 See Louise Gullifer, *Goode on Legal Problems of Credit and Security* (5th edn, Sweet & Maxwell 2013), p. 260

108 For instance, the Rascals case illustrates the intractable litigation well. Rascals is an acronym for Regulation and Administration of Safe Custody and Global Settlement, the proprietary acquisition and holding of securities system of Lehman Brothers. This system allowed the sale and purchase of securities *intra* affiliates as well as the sale of these securities to external clients. Consequently, the assets were not held in a trust-like manner. Internally, the system entailed the provision of repurchase agreements and open-ended securities lending agreements.[108] The value was documented in the account that initially purchased the underlying assets. However, given the rapid and automatic functioning of the operating system, the actual beneficial ownership of the underlying assets was, at least initially, unclear and subject to complex examination.

109 Re Lehman Brothers International (Europe)(In Administration) sub nom Five Private Investment Funds v Steven Anthony Pearson and Others (Joint Administrators of Lehman Brothers International (Europe)(In administration)) [2010] EWHC 2914 (Ch) at para. 36, see Charlotte Cooke, 'Lehman Brothers: certainty of trusts and the RASCALS litigation' (2011) 3 Journal of International Banking and Financial Law p. 136

110 Including Lehman Brothers Finance SA (LBF), Lehman Brothers Commercial Corporation Asia Limited and Lehman Brothers Asia Holdings Limited (two Hong Kong entities), Lehman Brothers Inc and Lehman Brothers Special Financing Inc

111 LBIE was subject to a capital charge equivalent to the full unsecured debt in relation to its affiliates

entails that low-quality assets are substituted by high-liquidity quality assets, thereby reducing risk-weighted assets.[112]

The master agreements most frequently used in cross-border transactions are the (i) New York law-governed Master Securities Lending Agreement published by the Bond Market Association, and the (ii) English law-governed Global Master Securities Lending Agreement ("GMSLA") published by the International Securities Lenders Association.[113] The GMSLA is drafted without reference to national law other than its governing law and jurisdiction clause. The agreement reiterates that despite the wording implying lending or similar actions, the master agreement envisages a title transfer of the securities.[114] The terms reflect market, not legal terminology.

Securities lending transactions do not have a fixed term. Either party can terminate the transaction on demand.[115] Subsequently, the transaction must be terminated within the ordinary market settlement period[116], which creates an obligation to re-deliver equivalent security. Parties can elect that margin to be calculated on a global basis, thereby indicating the overall exposure.[117] Alternatively, the parties can decide on calculation of margin on a transaction-by-transaction basis. Another similarity to repos is the ability to deliver a notice to the defaulting party upon the occurrence of an event of default, or if elected, automatic termination.[118] The corollary is that the transactions are accelerated. The concept of acceleration brings the transaction to its end, whereby the conventional methodology to determine the ultimate settlement price is used.

As explained above, securities financing transactions are divided into two legs. While the first leg is akin to the lending of cash or security, the reciprocal transaction of the second leg is the transferal of security by way of title transfer. Although akin to a secured loan, it cannot be characterised as such. The security would need to be retransferred to the debtor if title transfer is unenforceable. A creditor would need to prove his claim in insolvency, whereby the collateral can become entangled in lengthy insolvency proceedings, and the insolvency dividend may become diluted if assets are insufficient to satisfy higher ranking claims.

Intuitively, this technique encourages reliance on short-term funding. Moreover, since the collateral is transferred by way of title transfer, it is available to be re-used, or re-hypothecated as collateral, or serve as investment. A sequence of defaults leads to the intuitive argument that re-use or re-hypothecation risks insufficient security being available to honour the original arrangement. Securities financing transactions often allowed re-use or rehypothecation up to 100 percent or even 125 or 150 percent. Although re-use and re-hypothecation are not unique to securities financing transactions, securities financing transaction acitivty represents the most significant risk due to the size of the markets. This overuse reinforces the shortfall of security in the market, thus inflating it. In

112 This also helps financial institutions to comply with the liquidity coverage ratio, see Regulation 2015/61

113 There are national iterations which accommodate national law such as the French law-governed FBF Master Repurchase Agreement published by the Federation Bancaire Française or the German law-governed Deutscher Rahmenvertrag für Wertpapierpensionsgeschäfte (Repos) published by the BdB

114 Para 2.3

115 Para 8.1

116 This may vary per type of security and market, but usually ranges from overnight to three days

117 Para 5.4(a)

118 Para 10.1

fact, Mokal coined the term frothy markets.[119] Securities financing transactions regulation ("SFTR") seeks to mitigate this risk.[120] Besides the SFTR, another apporach is to regulate re-hypothecation as a financial product separate from the underlying transaction.[121] Current regulation applicable to financial derivatives requires the reporting of transactions and collateral, whereby imbalances or excessive over-use or over-rehypothecation should be noticed at individual and market level.[122] That does not suggest, however, that the use of security, such as collateral, should be restricted. To inform a possible solution, further insight into the disbalances is required..

1.3 Close-out netting and collateral

Close-out netting together with collateral creates a synergy that is central to risk reduction and management of today's financial markets. The quintessence of close-out netting arrangements is that no individual cross or countervailing claims exist. All transactions under the ISDA Master Agreement are deemed to constitute a single obligation. Thus, credit risk exposure is reduced to a single net exposure. In theory, the party owing the single amount must post collateral whose value can be used to discharge the net obligation.[123] However, parties often take the credit risk and other mitigation measures into account, and commercial arguments often take precedence over legal ones. Overall, credit risk becomes manageable. The following subsections will discuss the mechanism and objective of close-out netting and collateral as well as criticise its merits.

1.3.1 Close-out netting

Only over recent years has the term close-out netting started appearing in legal terminology.[124] In fact, close-out netting has no precise legal definition. Its appearance is dependent on the contractual provisions, which are address the specifities of the relevant jurisdiction of the parties.[125] Close-out netting has been described in multiple statutes.[126] Common to all definitions is that the term captures a process of three consecutive steps, as further explained below. Lightman J in *Enron Europe Ltd v Revenue and Customs Commissioners*[127] accurately described the underlying procedure of close-out netting, i.e. termination of all executory contracts and replacement of countervailing

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119 See Rizwaan Mokal, 'Liquidity, Systemic Risk, and the Bankruptcy Treatment of Financial Contracts' (2015) 10(1) Brooklyn Journal of Corporate, Financial & Commercial Law p. 9

120 Regulation 2015/2365, see William Yonge, 'An update on the EU securities financing transactions regulation' (2017) 18(1) Journal of Investment Compliance p. 78

121 Christina Tarnanidou, 'EU financial collateral arrangements and re-hypothecation in the shadow of 'shadow banking': To further regulate or not?' (2016) 17(3) Journal of Banking Regulation p. 200'

122 See ESMA, Questions and Answers: Implementation of the Regulation (EU) No 648/2012 on OTC derivatives, central counterparties and trade repositories (EMIR) (2 October 2017) and Regulation 148/2013

123 This credit support mechanism is dependent on the enforceability of close-out netting provisions. Apparently, if close-out netting were unenforceable, there would be a risk that the collateral transferred by way of security interest or title transfer would have to be proved in insolvency

124 Literature refers to close-out netting sometimes as termination netting. Termination in the context of the ISDA Master Agreement is called close-out to encapsulate Event of Default and Termination Events

125 Louise Gullifer, *Goode on Legal Problems of Credit and Security* (5th edn, Sweet & Maxwell 2013), p. 288

126 Reg 3 of the Financial Collateral Arrangements (No 2) Regulations 2003 (SI 2003/3226); Reg 2(1) of the Financial Markets and Insolvency (Settlement Finality) Regulations 1999 (SI 1999/2979); section 48(1)(d) of the Banking Act 2009

127 *Enron Europe Ltd v Revenue and Customs Commissioners* [2006] All ER (D) 195 (Apr)

transactions with a single amount. The primary objective of close-out netting is to provide legal certainty about the reduction of

> all present, future and contingent indebtedness to a single net balance… so that the exposure… is limited irrespective of the provisions of national insolvency rules[128]

In other words, close-out netting reduces the exposure, claim or obligation to a net amount, thereby mitigating the counterparty's credit risk. This concept regulates the consequences of events indicating an imminent or actual default, or of other events that make continuation of the transaction impossible. In contrast, common remedies under contract law require actual breach of contract and consequent adjudication or arbitration. Although damages could be awarded to the innocent party, close-out netting provides for predetermined rights and, accordingly, promotes certainty since it dispenses with the need to have recourse to adjudication or arbitration.[129] Intuitively, the benefits include reduction of costs and delay in enforcement related to the proceedings. In addition, close-out netting is not predicated on actual default or commencement of insolvency proceedings or a restructuring measure. In fact, an event of default may suggest a deterioration in financial standing such that early termination can be exercised at an earlier stage.

The the existence of set-off provisions can serve as an indicator of the court's willingness to recognise close-out netting. Set-off is usually a statutory mechanism which commonly forms part of insolvency laws. This mechanism envisages that countervailing claims and obligations are reduced to a single amount. While it resembles set-off, the major difference is that set-off requires various preconditions to be satisfied. The economic effect of close-out netting, which is a contractual mechanism, resembles statutory set-off. This similarity is suggested by the EU legislation that underpins the enforceability of close-out netting which refers to netting "agreements" or netting "provisions".[130] Set-off has a long-standing history[131] and can be equitable, procedural and statutory.[132] As a statutory measure, it is contained in insolvency law. While considerably facilitating the insolvency process, as it reduces the number of claims and obligations that need to be ascertained, the primary policy rationale is that it would be inequitable to enforce one party's obligations while disregarding closely connected claims. In other words, its objective is satisfaction *pro tanto*, i.e. reciprocal, of creditor and debtor claims upon insolvency. The crucial precondition is

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128 Louise Gullifer, *Goode on Legal Problems of Credit and Security* (5th edn, Sweet & Maxwell 2013), p. 295

129 During the financial crisis of 2007, this perception was tainted by a flood of litigation in courts and arbitration proceedings. The most famous example leading to a revision of the ISDA Master Agreement is the case of *Lomas v JFB Firth Rixson Inc* [2012] EWCA Civ 419. On balance, however, the overall mechanism has proven effective apart from technical issues, see Joanne Braithwaite, 'The impact of crises by way of the courts' (2014) 3 Journal of International Banking and Financial Law p. 147; Joanne Braithwaite, 'Law after Lehmans' (2014) LSE Legal Studies Working Paper No. 11/2014; Jeffrey Golden, 'The courts, the financial crisis and systemic risk' (2009) 4(1) Capital Markets Law Journal p. S141; David Baragwanath, 'How should we resolve disputes in complex international financing transactions?' (2012) 7(3) Capital Markets Law Journal p. 204; Michael Bridge and Joanna Braithwaite, 'Private law and financial crises' (2013) 13(2) Journal of Corporate Law Studies p. 361; Jonathan Ross, 'The case for P.R.I.M.E. Finance: P.R.I.M.E. Finance cases' (2012) 7(3) Capital Markets Law Journal p. 221; and Hon James Peck, 'Cross-Border Observations Derived from my Lehman Judicial Experience' (2015) 30(3) Journal of International Banking and Financial Law p. 131

130 See Bernadette Muscat, 'Draft proposals for new EU netting provisions: further harmonisation or fragmentation?' (2014) 2 Journal of International Banking and Financial Law p. 116

131 See Geoffrey Yoewart and Robin Parsons, *Yoewart and Parsons on the Law of Financial* Collateral (Elgar Financial Law and Practice 2016) p. 602

132 Ibid

therefore that the claims are mutual.[133] Another precondition for the application of set-off is that the claims or cross-claims are measurable in monetary terms.[134] Thus, for instance, individual contracts for which there is no market price, such as the delivery of commodities, cannot be recognised. Consequently, set-off cannot seamlessly operate in today's financial markets, since the preconditions cannot be continuously satisfied. In contrast to set-off, close-out netting is a recent innovation. Contrary to a widely held belief, it does not require the application of set-off – as discussed below. It is an elaborate mechanism, which differs from other common contractual risk mitigation arrangements in the sense that it operates bilaterally.[135] Most importantly, it contains termination provisions that are not limited to insolvency, but anticipate a possible default in the future, and valuation provisions. Nonetheless, due to the similarity of the economic outcome of set-off and netting, a court will be inclined to give effect to the close-out netting provisions.

Close-out netting may or may not employ set-off to achieve a net balance. For instance, the GMRA and GMSLA envisage acceleration of the various transactions, with subsequent set-off of all obligations. In other words, while the GMRA and GMSLA constitute close-out arrangements, the agreements themselves do not purport to be such agreements. They can be therefore referred to as overt set-off agreements. In contrast, the ISDA master agreement envisages that a single amount replaces the value of all transactions. It deems that all transactions constituted, at any point in time, a single transaction. Therefore, it may be stated that the ISDA master agreement constitutes a real close-out netting arrangement. In general, the enforceability of close-out netting can be analysed as follows. In contrast GMRA and GMSLA recognise the exitence of multiple transactions.

The method in the ISDA master agreement seems somewhat artificial. This distinction is not discussed in academic literature. However, it is not only of theoretical importance. The reason is that it underpins the single-agreement structure of the agreement. Whereas the GMRA and GMSLA acknowledge the existence of multiple transactions, the ISDA agreement presupposes that this single amount will be recognised as such and therefore requires a more robust legal framework.[136] The ISDA master agreement serves a commercial rationale and sensible purpose and is prejudicial neither to the debtor nor to the general body of creditors. To reiterate, in contrast to other contracts, the ongoing obligations are bilateral. This justifies why the default of one party allows reliance on the flawed asset provision, whereby the non-defaulting discontinuation of the transaction unless the default is cured or otherwise terminated before the initially envisaged maturity date.

The ISDA close-out procedure may seem complicated and theoretical, but the set-off approach suffers from significant shortcomings. The ISDA method is neither predicated on the existence of set-off nor, in principle, requires that the preconditions of set-off are met. In practice, since the

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133 See r 14.24 and r 14.25 of the Insolvency Rules 2016

134 Ibid

135 In contrast, traditional security arrangements such as mortgages protect merely one party, i.e. the mortgagee

136 This difference also arises from the divergence between securities lending transactions and financial derivatives and their use. While the former requires exchange of assets or assets for cash, the latter in principle does not require any exchange. Thus, securities financial transactions allow also for intra-trade netting – which promote the certainty that the obligation will never exceed the net obligation. This issue is however of relevance to developing markets and will therefore not be further discussed.

economic effect resembles set-off, courts uphold such agreements. English courts are most likely to do so, provided that voidability rules do not apply.[137] There is no inconsistency which could render the arrangement void.

1.3.2 The mechanism of collateral

Credit support in the form of collateral refers to the posting of security by way of title transfer or security interest. Title transfer means that the transfer of the security is coupled with an obligation of the collateral taker to re-transfer the collateral.[138] In contrast, in case of a security interest, the collateral provider retains the assets which are charged for the benefit of the chargee. These mechanisms are often referred to as collateralisation. Both mechanisms' purpose is that, upon failure of the defaulting party, the collateral can be seized or otherwise realised and applied against an outstanding claim to discharge the obligation. It militates against the risk of losing an unrealised gain. In other words, it supports transactions by reducing the expected loss if the counterparty defaults. Moreover, it ensures that the non-defaulting party can use the proceeds to swiftly rebalance its risk profile without incurring (excessive) losses. In addition, the value of the security is independent of the counterparty's solvency. Thus, both parties can considerably mitigate the expected ramifications following the counterparty's default.[139] This ability to mitigate credit risk has received regulatory recognition, whereby collateral arrangements are accorded special protection under insolvency law.[140] Hence, insolvency measures that would otherwise stay, suspend or cancel rights are enforceable, provided certain preconditions are met. Thus, to benefit from this protection, financial contracts arrangements must form part of, or be supported by, a qualifying collateral arrangement.[141]

1.3.3 Discussion

Critical academic literature challenges the legitimacy of close-out netting from a legal and economic perspective. Chapter 2 will disprove the legal challenge. A common belief is that credit risk mitigation techniques confer super-priority rights,[142] thereby impeding the distribution of assets in a "normatively defensible manner" – which is one of the main objectives of insolvency law.[143] This belief fails to appreciate the legal underpinnings of close-out netting and often presumes the offence of insolvency law without due regard to its provisions. A characteristic feature of the English legal tradition is that it is inclined to give effect to commercial contracts that do not offend public policy. For instance, Lord Hoffmann submitted that "the law is fashioned to suit the practicalities of life and legal concepts like 'proprietary interest', and 'charge' are no more than labels given to clusters of

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137 See section 2.4.3

138 There is no obligation to retransfer the original assets posted as security. Title transfer allows substitution with assets of an equal nature and quantum. Security interest is usually required each time the counterparties consent, depending on the bargaining power of the counterparties

139 David Murphy, 'The rising risks and roles of financial collateral' (2014) Journal of International Banking and Financial Law p. 3

140 See section 3.1

141 Ibid

142 Francisco Garcimartín and Maria Isabel Saez, 'Set-off, Netting and Close-out Netting' in Matthias Haentjens and Bob Wessels (eds) *Research Handbook on Crisis Management in the Banking Sector* (Cheltenham, Edward Elgar 2015) p. 38

143 Rizwaan Mokal, 'Liquidity, Systemic Risk, and the Bankruptcy Treatment of Financial Contracts' (2015) 10(1) Brooklyn Journal of Corporate, Financial and Commercial Law p. 9

related and self-consistent rules of law".[144] However, insolvency law contains apt provisions to render void and unenforceable contracts that seek to circumvent the effect of insolvency law.[145]

Legal commentators have, however, often embraced an economic argumentation to challenge the legitimacy of credit risk mitigation techniques. While the economic challenge holds some truth, the merits of the conjecture are often overstated. It considers, for instance, that early termination rights can impede the effective rehabilitation of a distressed financial institution or worsen the distress experienced by the institution and adversely affect asset values. However, the merits do not have general validity but are context-dependent.[146] Whereas in market-wide distress this may indeed materialise, a failure of a single institution, irrespective of its size, is unlikely to produce such effects. Moreover, the evolving financial institution framework mitigates and even prevents the ramifications. Negating the beneficial effects of credit risk mitigation techniques on financial markets contributes to risk and volatility of financial markets - also in the absence of failures of financial institutions. Negating the beneficial effects of credit risk mitigation techniques risks undermining the essential risk allocation that underpins today's financial markets. Therefore, it is necessary to elucidate the circumstances in which credit risk mitigation techniques may contribute to heightened risk and any relevant remedies. This thesis illustrates that resolution can serve to militate against the unintended risks.

Academic literature advocates the restriction of close-out netting and thereby inevitably financial contracts. It claims that the conjecture that close-out netting reduces systemic risk is ambiguous. Mokal's argumentation for instance is threefold. First, the premise hinges on the "outdated" notion of systemic risk with a microprudential focus;[147] second, it is theoretically flawed; and third, it is empirically false.[148] From a macro-prudential perspective, Mokal argues that the elements constituting close-out netting arrangements[149] contribute to systemic risk. He claims that it "increases common exposures to risk, systemic uncertainty, procyclicality, and leverage while reducing lending standards, collateral utilisation, and regulatory capital buffers".[150] However, it fails to appreciate the suitability of prudential and conduct regulation or to sufficiently distinguish between its merits. Moreover, it over-emphasises the occurrence of market-wide distress and negates the beneficial effects resulting from more frequent failures of single institutions. Most importantly, financial resolution regimes are more prolific at reducing any adverse implications arising from failures.

This fallacy is a corollary of the misconception about the use and form of the said financial instruments. For example, cash products, such as mortgage-backed securities and collaterised debt obligations, which indeed contributed significantly to or caused the financial distress, are falsely

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144 Morris v Rayner Enterprises Inc; Re Bank of Credit & Commerce International SA (No. 8) [1998] AC 214; [1997] BCC 965

145 See section 2.4.3

146 See section 4.3.2.2

147 See section 4.3

148 Rizwaan Mokal, 'Liquidity, Systemic Risk, and the Bankruptcy Treatment of Financial Contracts' (2015) 10(1) Brooklyn Journal of Corporate, Financial & Commercial Law p. 9, p. 15

149 "[Early T]ermination, market-to-market valuation, netting and unimpeded collateral" Rizwaan Mokal, 'Liquidity, Systemic Risk, and the Bankruptcy Treatment of Financial Contracts' (2015) 10(1) Brooklyn Journal of Corporate, Financial & Commercial Law p. 9 p. 15

150 Rizwaan Mokal, 'Liquidity, Systemic Risk, and the Bankruptcy Treatment of Financial Contracts' (2015) 10(1) Brooklyn Journal of Corporate, Financial & Commercial Law p. 9, p. 15

subsumed into the group of financial contracts.[151] In contrast to the cash products, financial contracts did not facilitate and promote excessive exposure to the inflated US real estate sector in 2007. It is also claimed that financial contracts may have contributed to the interconnectedness of financial institutions, thereby promoting the spreading of distress and overreliance on short-term liquidity funding. However, evidence suggests that these claims do not correspond with reality and are unsubstantiated.[152]

1.4 Fundamentals of resolution

The financial crisis of 2007 revealed the critical limitations of the legal regime governing crisis financial management. As a response, the English legislator introduced the Banking Act 2008 and subsequently the Banking Act 2009, which established the permanent resolution framework.[153] In 2015, the other Member States of the European Union also established a harmonised, permanent regime by transposing the Bank Recovery and Resolution Directive ("BRRD"),[154] whereby the relevant authorities, namely the Bank of England ("BoE") as resolution authority, were given new powers. The English legislator chose to adapt the existing regime in order to comply with the BRRD.[155]

1.4.1 Concept

To illustrate, resolution regime is situated between heightened supervision of an ailing financial institution, on the one hand, and insolvency proceedings or reorganisation measures under general company insolvency law, on the other. Indeed, resolution constitutes a novel legal framework which borrows concepts related to insolvency law but also introduces various new measures – which are exercised by administrative, not judicial bodies. In England, the Banking Act 2009 contains the most significant part of the resolution regime and of the special insolvency regimes pertinent to financial institutions. The effect of the measures is, not least, that losses are allocated to creditors without requiring commencement of formal insolvency proceedings. It allows, amongst others, (partial) rescue of the financial institution, which serves the overall objective of safeguarding financial stability. Apparently, the effects of resolution must resemble those of insolvency. Affected parties must at least receive the same economic treatment in resolution as in a hypothetical insolvency scenario.

The concept of resolution has been considered as a special form of insolvency law relating to the financial institution.[156] However, it does not substitute the current regime, nor does it represent some

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151 James Crotty, Structural Causes of the Global Financial Crisis: A Critical Assessment of the 'New Financial Architecture' (2009) 33 Cambridge Journal of Economics p. 563; Thomas Huertas and Maria Lastra, 'The Perimeter Issue: To what extent should lex specialis be extended to systemically significant financial institutions? An exit strategy from too big to fail' in Rosa Lastra (*ed*) *Cross-border bank insolvency* (Oxford University Press 2011) pp. 271-272

152 See section 4.3.2

153 Michael Schillig, *Resolution and Insolvency of Banks and Financial Institutions* (Oxford University Press 2016) paras. 1.05 et seq

154 Directive 2014/59

155 In contrast, other EU member states have transposed the BRRD almost in *verbatim*

156 See Andrew Campbell, Rosa Lastra, 'Definition of Bank Insolvency and Types of Bank Insolvency Proceedings' in Rosa Lastra (ed) *Cross-border bank insolvency* (Oxford University Press 2011); Seraina Grünewald, *The resolution of cross-border banking crises in the European Union: A legal study from the*

form of alternative, and its application is exclusive once certain preconditions for resolution are met. Moreover, administrative authorities and not the judiciary are conferred the powers to adopt and execute the measures. Most importantly, it can be applied before the commencement of normal insolvency proceedings. While liquidation serves to satisfy creditor claims and the rehabilitation of distressed entities, the resolution has the novel objective of promoting financial stability by mitigating any ramifications that may result from the failure of a financial institution; and expressly protects depositors. Crucially, it does so without recourse, or at least minimises recourse, to public funds, i.e. bail-outs.[157] Its approach is to allocate losses before having to initiate insolvency, thereby maintaining the franchise value and some parts of the distressed financial institution that are deemed essential for financial stability .

Insolvency law carves out a variety of contracts related to collateral from the scope of the ordinary stay, due to the essential functions served by these instruments. An abrupt and early termination can constitute a significant obstacle to the continuation of the business operations of the non-defaulting financial institution. Moreover, early termination of financial contracts is liable to the risk that the realised value following close-out and realisation of the collateral will, depending on the market situation, be significantly less than on ordinary termination. Due to the significant exposures, the consequent monetary loss can be extensive if not prohibitive. In other words, the exercise of close-out netting may exacerbate and reinforce distress by snowballing realised loss. It explains why the post-crisis agenda contained the objective of restricting termination in order to preserve necessary liquidity and access to essential services. Within resolution, early termination impedes the continuation of integral transactions for the purpose of risk and liquidity management.

Moreover, early termination may form significant obligations and deprive the financial institution of valuable assets. Since the price and terms of financial contracts depend on the credit standing, a financial institution subject to resolution will inevitably face significant problems in concluding new transactions, unless a governmental entity or third party provides a guarantee assuring the contingent obligations. Overall, the unrestricted ability of counterparties to terminate their transactions renders a resolution strategy less successful or even futile.

1.4.2 Policy rationale

During the financial crisis of 2007, competent authorities faced considerable legal and practical obstacles in both effectively rehabilitating distressed financial institutions, containing ramifications,

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perspective of burden sharing (Wolters Kluwer 2014) p 14 and Lynette Janssen, 'Bail-In from an Insolvency Law Perspective' (2017) Leiden Law School Research Paper No. 2962403

157 Catarina Fernandes, Jorge Farinha, Francisco Vitorino Martins and Cesario Mateus, 'Determinants of European banks' bailouts following the 2007-2008 financial crisis' (2016) 19(3) Journal of International Economic Law p. 707, Simon Gleeson, 'The role of government, central banks and regulators in managing banking crisis' in John Raymon LaBrosse, Rodrigo Olivares-Caminal and Dalvinder Singh (eds) *Financial Crisis Management and Bank Resolution* (Informa, 2009), Ross Delston and Andrew Campbell, 'Emergency liquidity financing by central banks: Systemic protection or bank bail-out?' (2005) 3 International Monetary Fund Current Developments in Monetary and Financial Law. There are still exceptions permitting replenishment of regulatory capital with public funds, provided strict preconditions are satisfied, see Communication from the Commission on the application of State aid rules to support measures in favour of banks in the context of the financial crisis dated 1 August 2013 (2013/C 216/01) and Art 32(4)(d)(iii) of the BRRD

and liquidating failing institutions.[158] Given that the bail-out funds were mostly used to restructure maturing debt and replenish capital shortfalls, public funds were transferred to "private hands". While constituting restricted state aid, such support is undesirable from a political point of view due to significant opposition resulting from this "misappropriation". In addition, bail-outs exposed sovereigns to failing institutions, whose turnover often exceeded sovereigns' gross domestic product.[159] This exposure arguably contributed to the sovereign debt crisis following the financial crisis of 2007.

Often politically motivated and instrumentalised, bail-outs instigated the development of resolution regimes. A re-occurring and associated notion was "too-big-to-fail",[160] meaning that individual institutions, mostly large investment firms, had to be bailed out in order to prevent systemic ramifications. Since these institutions operate with often misapprehended and seemingly complex financial products, objections were raised against resorting to public funds. Although these have already been partly repaid, a bitter aftertaste has remained. A lesson learnt was thus that owners of distressed financial institutions and their investors should fund the rehabilitation or restructuring.

1.4.3 Banking Act 2009

Member States gave effect to the main parts of the BRRD as of 1 January 2015. While some Member States implemented the Directive almost verbatim, the English legislator adapted the existing framework to comply with the BRRD's substance.[161] The implementation required a series of statutory instruments[162] amending the primary legislation on financial institution crisis management, the Banking Act 2009, as well as other relevant legislation, such as the Financial Services and Markets Act 2000 and the regulatory handbooks of both the Financial Conduct Authority and Prudential Regulatory Authority.

The main transposition instrument, the Bank Recovery and Resolution (No 2) Order 2014, contains the procedural requirements to be met by the relevant authorities, namely the BoE, the Prudential Regulatory Authority, the Financial Conduct Authority and the HM Treasury, when exercising the resolution powers, or stabilisation options in Banking Act 2009 parlance. The reason for expressly imposing procedural requirements is that the single and combined effect of the stabilisation options can significantly interfere with contractual and property rights, including those provided by credit risk mitigation techniques relating to financial contracts. Presumably, the most invasive stabilisation option is the power to cancel or reduce property rights. Another ancillary measure is the suspension

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158 Michael Schillig, *Resolution and Insolvency of Banks and Financial Institutions* (Oxford University Press 2016) paras. 2.02 et seq

159 Sideek Seyad, 'A legal analysis of the control of national budgets by the EU institutions' (2015) 30(5) Journal of International Banking Law and Regulation p. 251

160 Malcom Knight, 'Mitigating moral hazard in dealing with problem financial institutions: Too Big to fail? Too interconnected to Fail?' in John Raymond LaBrosse, Rodrigo Olivares-Caminal and Dalvinder Singh (eds) *Financial Crisis Management and Bank Resolution* (Informa, 2009) p. 258

161 HM Treasury, Explanatory Memorandum to the Bank Recovery and Resolution (No 2) Order 2014 (No 3348, 2014)

162 The main statutory instruments include The Bank Recovery and Resolution Order 2014, The Bank Recovery and Resolution (No. 2) Order 2014, The Bank and Building Societies (Depositor Preference and Priorities) Order 2014 2, The Banking Act 2009 (Mandatory Compensation Arrangements Following Bail-in) Regulations 2014, The Banking Act 2009 (Restriction of Special Bail-in Provision etc.) Order 2014, The Building Societies (Bail-in) Order 2014

of rights or even prohibition of events of default lined to resolution measures. To some extent, this measure substitutes the contractually devised contractual risk allocation under the master agreements, with discretion conferred on the BoE. It constitutes a paradigm change. Now the overall stability of the financial markets outweights the certainty of financial market participants.

The Government nevertheless opined that these powers were "justified and proportionate to the public interest".[163] It is, however, essential that the stabilisation options are only exercised subject to appropriate safeguards and forseeable. In the absence, precarious uncertainty ensues for market participants. In order to prevent adverse developments, establishing clarity regarding the execution of stabilisation measures and their effect on contractual and property rights is of utmost importance. Thus, it is crucial to understand the stabilisation options and related safeguards in relation to credit risk mitigation techniques and financial contracts. Such exercise can also inform the discurse on the desirability of close-out netting and motivate objections.

1.5 Problem statement, methodology and structure

The general understanding of both financial contracts and credit risk mitigation techniques suffers from conceptual weaknesses that misinform the evolving regulation. Financial contracts are widely misperceived and threats overemphasised. Credit risk mitigation techniques fulfil a crucial function by reducing systemic risk[164] and promoting the use of assets in an economy. The (academically) contested benefits, which were traditionally favoured by policymakers and are still advocated by practitioners (including regulators), hinge on the assertion that close-out netting reduces credit risk to a fraction – thereby diminishing the risk that failure of one financial institution adversely affects its counterparties. Moreover, close-out netting promotes liquidity by releasing assets that would otherwise be encumbered as security (which is another method to reduce credit risk). Also, it promotes market liquidity[165] by abolishing legal limitations to the interchangeable use of security.[166]

Before the financial crisis, the legal protection afforded to financial contracts and credit risk mitigation had evolved into a broad endorsement. It is predicated on a micro-prudential institutional perspective which postulates that the precondition for financial stability is the reduction of credit risk. The overall objective is to prevent a domino effect of failures. However, the financial crisis revealed that such interconnection occurs on other levels. The efficient allocation and distribution of credit risk was also a crucial driver in the elaboration of the master agreements. It allowed private parties to efficiently manage credit risk and envisage the effects of a default – thus promoting certainty. As a response to the financial crisis of 2007, this risk management function was seized by resolution authorities.

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163 HM Treasury, *Explanatory Memorandum to the Bank Recovery and Resolution (No 2) Order 2014 (No 3348, 2014)* para 7.6; see also Eva Hüpkes, 'Insolvency: Why a special regime for banks?' (2005) 3 International Monetary Fund Current Developments in Monetary and Financial Law p. 473; Tommasso Padoa-Schioppa, *Regulating finance – balancing freedom and risk* (Oxford University Press 2004) p 61

164 See section 4.3.2

165 David Mengle defines liquid market as "one in which it is possible to transact immediately with minimum effect on price and minimum loss of value", and considers four dimensions of liquidity: immediacy, cost, depth, and resiliency. David Mengle, 'The economic role of speculation' (2010) 4 International Derivatives and Swaps Association, Research Notes No. 2

166 Provided the quality and quantity of the substitute is the same as will be discussed below

After the crisis, these misconceptions led commentators and some policymakers to articulate concerns that credit risk mitigation techniques might excaberate the distress or impede the rescue of distressed financial institutions. On a global and national level legislators and regulators examined the prohibition and suspension of certain private rights by giving regulators further powers to interefere and discretion in its exercise. This is inconsistent with the ascribed benefits of credit risk mitigation techniques. This manifest collision is however also based on an apparent reorientation of the regulatory perception and legal reform that remediates grave limitations identified during the financial crisis.

With the recovery and resolution powers, legislators conferred substantial powers on authorities. These powers involve the right to expressly override, cancel, defer, stay or suspend credit risk mitigation techniques. The rationale is that failure of individual institutions is inevitable. Resolution averts systemic implications by ensuring that systemically relevant parts of financial institutions continue operating as going concern.

Such a process is called bail-in. The application of bail-in to also financial contracts creates significant uncertainty. However, the nature of financial contracts resembles that of utilities and makes parties more akin to operational service providers than to financial investors. Bail-in recommendations at FSB level merely envisaged application to latter. Europe is unique in applying bail-in to financial contracts and thus significantly reconfigures the market structure. Undoubtedly, the presence of the European resolution regime considerably affects the certainty related to credit risk mitigation techniques and financial contracts.

1.5.1 Problem statement

The intrusive intervention powers of resolution authorities apparently reverse the process of incremental protection of credit risk mitigation techniques and the resulting certainty established by market participants, inevitably leading to uncertainty. This support was advocated at the global level by the Financial Stability Board.[167] During the financial crisis, it also transpired that the rescue of financial institutions is capital intensive. Concurrently, the consensus grew that recourse to public funds must be restricted as it creates market distortions and, inevitably, increases public pressure.[168] Considering that financial contracts represent most of the financial institutions' obligations, it is no surprise that the legislators sought to extend measures that permit the write-down of liabilities and conversion of liabilities to equity arising from financial contracts.[169]

To date, there is no analysis of the merits of close-out netting and collateral in the context of bank insolvency and resolution under English law. This thesis fills this gap by challenging various of the academic arguments against netting, discerning the principal risks and exploring how the evolving

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[167] Financial Stability Board, Key Attributes of Effective Resolution Regimes for Financial Institutions (2011 as amended in 2014)

[168] There had been various concerns that the use of public funds procured through general taxes could be inequitable if serving to satisfy private creditors' claims. See European Commission, *Information from European Union Institutions, bodies, offices and agencies: Communication from the Commission on the application of State aid rules to support measures in favour of banks in the context of the financial crisis* ("Banking Communication") from 1 August 2013 (2013/C 216/01)

[169] See Matthias Lehmann, 'Bail-in and private international law: how to make bank resolution measures effective across borders' (2017) 66(1) International & Comparative Law Quarterly p. 107

bank resolution regime mitigates adverse implications. It argues that contrary to critics' misconception, close-out netting deprives neither the debtor nor the general body of creditors of assets.[170] Nor does it alter the insolvency hierarchy or otherwise offend insolvency law. English law does not prohibit clauses permitting termination due to insolvency, which are commonly referred to as *ipso facto* clauses. Such right is firmly entrenched in the principle of contractual freedom and commercial reasonableness.[171] However, this does not contradict the argument that there are good reasons to temporarily restrict enforcement in order to ensure contractual stability. This is necessary to stabilise financial institutions and thereby promote financial stability. Financial derivatives and securities financing transactions are utilities for financial institutions and integral to their survival, which was also agreed at global level. Implementation of these standards has however gone too far by treating financial derivatives and securities financing transactions as investments. Counterparties are thereby treated as common investors who wilfully assume credit risk in return for dividends or interest. This regime also serves as a means to introduce administrative powers that undermine the regulatory framework in Europe and are detrimental to the international competitiveness of EU financial institutions.

This thesis seeks to elucidate the enforceability of credit risk mitigation techniques in the context of financial institution resolution. It aims to formulate a new perspective and provide insights into a controversial question in legal scholarship: it challenges, from a legal perspective, the extent to which close-out netting arrangements should be privileged under national law. Legal literature discussing this issue from an English law perspective is scarce.[172] In particular, literature reflecting on the implications of resolution for credit risk mitigation techniques and financial contracts seems to have received little attention.[173] The context of resolution is helpful due to the apparent diametrically opposed objectives of resolution and close-out netting, i.e. rehabilitation of distressed parts of financial institutions as opposed to early termination and regulating the consequences of a default to protect the non-defaulting party. Moreover, due the paucity of application of resolution measures under the Banking Act 2009 in its current form or under similar regimes in other jurisdictions, a theoretical assessment of potential implications is indispensable.

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170 See section 2.4

171 Jeffrey Golden, 'Interpreting ISDA terms: when market practice is relevant, as of when is it relevant?' (2014) 9(3) Capital Markets Law Journal pp. 299 et seq; Shearman & Sterling, 'Case Comment: United Kingdom: financial instruments - determination with consent' (2014) 29(7) Journal of International Banking Law and Regulation p 74 and Reshma Korde, 'Good faith and freedom of contract' (2000)7 UCL Jurisprudence Review p. 142

172 See Philipp Paech, 'Repo and derivatives portfolios between insolvency law and regulation' (2017) LSE Law, Society and Economy Working Paper 13/2017. At the time of writing, the) English law perspective is unique. English law serves as a basis for further studies, since its approach towards financial derivatives and close-out netting is most favourable, see section **Error! Reference source not found.**. It shows that there is, in principle, no need for safe harbours, i.e. clauses that carve out close-out netting arrangements from insolvency. Such insight allows a better understanding of the real risks of close-out netting arrangements and the need for Regulation or even intervention

173 See Stephen Connelly, 'The Implementation of the EU Bank Recovery and Resolution Directive's Derivative Bail-In Powers in the UK' in Jens-Hinrich Binder and Dalvinder Singh (eds) *Bank Resolution: The European Regime* (Oxford University Press 2016)

1.5.2 Methodology

An analysis of close-out netting and resolution requires consideration of a variety of legal disciplines and sources. The prevailing debates on the legitimacy of privileges have focused on the US Bankruptcy Code.[174] Reference to these debates requires caution, since the discussion must be framed by national law and the policy justifications legitimising the exemptions.[175] The European acquis contains various legislative packages that protect the enforceability of credit risk mitigation techniques and promote their use. It has been argued that this reform was the result of industry advocacy, which suggests that its very existence is of doubtful value.[176] Advocacy entails the delivery of advice motivated by industry expertise and needs, not undue influence on the legislative process.[177] Hence, the merits and not the existence of the legislation should be questioned. In the context of the legitimacy of the Financial Collateral Directive ("FCD"), Gullifer[178] reports the following problems in balancing the default regime and the FCD-established exemptions:

> … it needs to be recognized that there will be countervailing practical considerations of very considerable importance… In order to draw a line, the law must use criteria to reflect the optimal policy outcome but which are also readily identifiable in any given factual situation.

The European legislative procedure is practice-oriented, which lacks critical discussion on a substantial issue such as legitimacy. Where it needs to be transposed into the national framework, challenges may indicate where it would offend or contravene national public policy. The following discussion proves that the transposition of "netting" legislation did not represent an obstacle. As mentioned above, resolution is inextricably linked to insolvency. Consequently, the assement of merits and challenges requires an analysis also of English insolvency. Given the intrusive powers and discretion conferred on the BoE, it is germane to discuss the process that led to the new regime. In particular, it must be examined whether the measures are proportionate in light of the lessons learnt during the financial crisis, and safeguards and remedies for aggrevated market participants appropiate.

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174 Cf. Rizwaan Mokal, 'Liquidity, Systemic Risk, and the Bankruptcy Treatment of Financial Contracts' (2015) 10(1) Brooklyn Journal of Corporate, Financial & Commercial Law p. 9, Mokal exposes Louise Gullifer and Philipp Paech as the most notable exemptions, see Louise Gullifer 'What Should We do About Financial Collateral' (2012) 65 Contemporary Legal Problems p. 307 and Philipp Paech, 'The Value of Financial Market Insolvency Safe Harbours' (2016) Oxford Journal of Legal Studies p. 1, respectively. For an overview of the US discussion see section 2.4.2.2

175 For an overview of the US regime in relation to derivatives, see Gabriel Moss QC, 'Anti-deprivation, flip clauses, ipso facto rules and the Dante inferno: Lehman Brothers Holdings Inc v Bank of American National Association Judge Chapman 28 June 2016' (2017) 30(2) Insolvency Intelligence p. 34 and, more extensively, Sylvie Durham, *Derivatives Deskbook* (2nd edn, Practising Law Institute, New York City) paras 7.1 et seq

176 See Glenn Morgan, 'Reforming OTC markets: the politics and economics of technical fixes' (2012) 13(3) European Business Organization Law Review p. 391 and Colin Scott and John Biggins, 'Public-private relations in a transnational private regulatory regime: ISDA, the state and OTC derivatives market reform' (2012) 13(3) European Business Organization Law Review p. 309

177 See the 2006 ISDA Model Netting Act dated 10 October 2007 and the International Derivatives and Swaps Association, *Memorandum on the Implementation of the Model Netting Act* (2006) available at https://www2.isda.org/functional-areas/legal-and-documentation/opinions/ <accessed on 16 September 2017>

178 Louise Gullifer, 'What should we do about financial collateral' (2012) 65 Current Legal Problems p. 377, p. 378

1.5.3 Structure of the thesis

The thesis is structured as follows. Chapter 2 introduces credit risk mitigation techniques. It illustrates the crucial function of financial contracts for today's financial markets. As part of the illustration, the perceived risks and benefits have to be discussed. It is submitted that financial contracts play a fundamental role in mitigating otherwise uncontrollable volatility and other risks inherent in financial markets. Overall, financial contracts are beneficial for the economy and public prosperity.[179] They require an efficient functioning of the validity and enforceability of credit risk mitigation techniques . While it is impossible to clearly discern the risks and benefits of these risks, the discussion aims to disprove common misconceptions widely held prejudices held by academia and policymakers. This chapter examines the legitimacy of credit risk mitigation techniques from an insolvency law perspective. It elucidates that they do not subvert, offend or defeat the purpose of insolvency law. This fallacy follows from a lack of appreciation of the general restrictions, shams and provisions circumventing the effect of insolvency law.

Chapter 3 discusses EU legislation and its English transpositions that promote and protect the use of credit risk mitigation techniques. It suggests that there is an accepted policy justification. Regulation has even endorsed the use of credit risk mitigation techniques by reducing regulatory capital requirements, which is the capital that financial institutions must set aside to absorb potential loss. It is also submitted that by promoting the use of credit risk mitigation techniques the EU legislator has sought to contribute to the integration and efficiency of financial markets. The effect is that risks and volatility inherent in financial markets are reduced while contributing to economic prosperity. Moreover, the presence of credit risk mitigation techniques is recognised as an essential mechanism to reduce the risk for financial markets arising from a counterparty's default.

Chapter 4 reflects on the events that unfolded during the financial crisis and the implications for and role of financial contracts. During the crisis, wide consensus formed on the unsuitability of insolvency law for the disolution of distressed financial institutions. It is argued that, contrary to common belief, insolvency law is still relevant and has not been substituted by resolution, which will be discussed in Chapter 5. This discussion provides a theoretical analysis of the understanding and management of risk. It illustrates that financial contracts are falsely blamed for the effects of the financial crisis of 2007. However, they can contribute to financial institutions' distress in certain circumstances. Consequently, intervention may be warranted. In addition, this chapter will reflect on the international development of standards that formed the basis for today's resolution regime.

Chapter 5 deliberates on the modified insolvency law related to financial institutions and resolution regimes. It examines the enforceability of credit risk mitigation techniques under the Banking Act 2009. The aim is to elicit the meaning of the overarching objective of this act and its interrelation with financial contracts and credit risk mitigation techniques. By describing various measures that affect enforceability, this chapter reminds of the importance of credit risk mitigation techniques. Thus, although the Banking Act expressly permits interference in order to serve the overarching objective

[179] David Mengle, 'The Importance of close-out netting' (2010) 1 International Derivatives and Swaps Association, Research Notes available https://www.isda.org/a/USiDE/netting-isdaresearchnotes-1-2010.pdf <accessed 07 February 2019>

of protecting financial stability, its resolution measures are subject to various safeguards that seek to protect the enforceability of credit risk mitigation techniques credit risk mitigation techniques and restitute aggrevated creditors.

Chapter 6 investigates the risks emanating from the shift of powers away from the courts to the BoE. The protection provided by the EU netting legislation needed to be adapted to permit EU resolution and the BoE to realise its objective. In particular, it is submitted that the insights resulting from the financial crisis of 2007, have shown that powers under the Banking Act 2009 need to be carefully balanced with contractual certainty. It is submitted that while being explicitly allowed to affect credit risk mitigation techniques, the BoE should seek to avoid interfering with financial contracts and credit risk mitigation techniques. This chapter will scrutinise the discretion that can be exercised by the BoE as well as elements that militate against disproportionate use or compensating disproportionally affected creditors. Lastly, it will contemplate the current proposals to revise the Bank Recovery and Resolution Directive, which seeks, amongst others, the introduction of moratorium powers, i.e. the right to stay or suspend contractual and substantive rights – without the concurrent use of another resolution measure. It argues that, although stay or suspension may be adequate in certain circumstances, it is not a tool in itself but only an ancillary instrument. However, this chapter demonstrates the failure of the legislator and resolution authorities (other than the BoE) to appreciate the peculiarities of financial contracts and credit risk mitigation techniques. The discussion on the merits of the moratorium powers also allows reflecting on the anticipated challenges it poses. Overall, the discussion submits that the proposal has an inherent propensity to undermine the objective of resolution.

Chapter 7 concludes this thesis by summarising its conjectures. It thereby puts in context the discussion on financial contracts and credit risk mitigation techniques and examines the merits of the measures that affect these techniques under the Banking Act 2009. It reiterates the considerations arising from shifting the power away from courts to the BoE while conferring broad new powers and discretion. Overall, the last chapter sets out policy recommendations cautioning against widening the discretion of resolution authorities and rights to interfere in financial contracts and credit risk mitigation techniques.

Chapter 2
Close-out netting

The previous chapter introduced the concept of master agreements, whereby parties seek to establish a long-term contractual relationship. Master agreements govern multiple transactions and include rules which are as "simple, clear and strict" as possible.[1] Chief is the rule regulating the consequences of a party's default. These default rules are contractual self-help remedies that can be enforced without the court's assistance. Master agreements seek to prevent that the relationship is upset by inadequate default rules and ensure that relational norms are better enforced.[2] After having considered the objective of this thesis and introduced some of the fundamental principles in Chapter 1, this chapter analyses the legitimacy of close-out netting from an English law perspective. A novelty in this discussion is the analysis of the often unchallenged misconception that close-out netting is prejudicial to the debtor and to the general body of creditors. The merits of this argument will be examined in the context of the avoidance rules contained in insolvency law. It will be argued that the benefit of credit risk mitigation techniques is more suitable to mitigate the risks inherent in trading relationshios than general remedial measures under English law.[3] It should not come as a surprise that market participants are better able to devise a system more apt to identify imminent distress and prompts remedial measures.[4] The following chapters will reflect on the need for contractual stability facilitated by temporary stays. Overall, this chapter answers why *ipso facto* and close-netting should not be restricted. It purports that the benefits of close-out netting can exceed its challenges. This is further evidenced in Chapter 3. The remainder of this chapter is structured as follows.

The first section discusses the public policy rationale underpinning the enforceability of close-out netting. Besides the principles of contractual freedom and commercial reasonableness, the enforceability of close-out netting is firmly ingrained in the general and insolvency laws of England. The contractual close-out netting provisions do not conflict with statutory provisions; in fact, master agreements resemble the operation of statutory set-off with modifications to adapt the measure to today's financial markets requirements. The academic objection is a corollary of relevant US literature and the importance falsely attributed to certain insolvency law principles and measures while disregarding others. This serves to demonstrate that commercial reasonableness can be reconciled with and forms part of English jurisprudence and public policy.

The second section discusses the benefits of close-out netting. Appreciation of the economic effects is beyond the scope of this thesis.[5] The assessment made in this section seeks to motivate the

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1 Jonathan Morgan, Contract Law Minimalism: A Formalist Restatement of Commercial Contract Law (Cambridge University Press 2013) p. xiii

2 Ibid

3 Cf. Joanne Braithwaite, 'Standard Form Contracts as Transnational Law: Evidence from the Derivatives Markets' (2012) 75(5) Modern Law Review p. 779, p. 789

4 Ibid

5 Appreciation of econimic literature requires a different framework to appreciate the findings ans conclusion. Such a discussion goes beyond the purpose of this thesis. See David Mengle, 'The

benefits from a reasoned and pragmatic point of view. Enforceable netting arrangements allow financial institutions to calculate exposures on a net basis. Given the enforceability, the resulting net amount may be based on the mark-to-market value of the various transactions encompassed in the netting arrangement. The value of collected collateral can be used to discharge this net obligation, thereby eradicting the credit risk. The discussion on the benefits will be assessed from the perspective of the financial institution and that of financial stability.

The third section assesses the risks and challenges using US studies, due to the paucity of English critical scholarship. The literature can be divided into four strands, namely that close netting (i) increases the risk profile[6] of market participants, (ii) frustrates the rehabilitation of a distressed debtor, (iii) is prejudicial to the general body of creditors and (iv) reduces the value of the debtor's estate. These arguments suffer from the same substantial weakness, since they fail to satisfactorily consider the entirety of insolvency law. In relation to financial institutions, the main argument is that close-out netting undermines contractual stability necessary for the recovery of distressed institutions. Contractual stability does not form part of the existing insolvency regimes applicable to complex and large institutions; however, it has been introduced in relation to financial institutions under the BRRD.

The fourth section discusses the enforceability of close-out netting in the context of insolvency law. It elucidates the fundamental procedures and protections applicable to all parties affected by distress, viz. the debtor, general body of creditors and creditors benefiting from credit risk mitigation techniques. This is discussed in the context of avoidance rules. These rules serve to strike a balance between, on the one hand, commercial certainty and freedom of contract, and, on the other hand, rights of third parties. Voidance rules do not apply if parties act at arm's length, which means that parties act in their own interest and wituout exercising undue influence. Such permits to analyse the inconsistency with the legal framework. This section demonstrates that close-out netting is not prejudicial to the debtors' or the general body of creditors' assets. It clarifies that, contrary to common misperception, there is no presumption against *ipso facto* clauses in English law. A non-defaulting counterparty owed a net amount ust prove its claim as unsecured creditor and will receive insolvency dividends in accordance with the statutory insolvency hierarchy.

The last section concludes this chapter. Reflecting on the foregoing sections, it contextualises the benefits and challenges of close-out netting. It is maintained that although close-out netting can pose practical challenges to the rehabilitation and recovery of the debtor, it does not offend English insolvency law and is, in fact, based on its general principles.

2.1 Discerning the elements of close-out netting

Close-out netting may be invoked prior and after commencement of insolvency proceedings. Before the commencement of insolvency, close-out netting is enforceable as a principle of freedom of contract and commercial reasonableness – and is consequently subject to the ordinary rules of

Importance of close-out netting' (2010) 1 International Derivatives and Swaps Association, Research Notes available https://www.isda.org/a/USiDE/netting-isdaresearchnotes-1-2010.pdf <accessed 07 February 2019>

6 It describes the risk adaption or concentration in an entity

contract law. Limitations arise from the law on penalties. English courts have the discretion to restrict or enforce injunctive relief or specific performance if they deem the granting of damages *in lieu* more equitable.[7] Moreover, the claim may become subject to set-off (as explained below) or counterclaim. Similarly, the validity of the contractual arrangements is predicated on the absence of misrepresentation, illegality, fraud, duress, undue influence and mistake. Therefore, the precondition is that it complies with the principles of English contract law and both parties acted without awareness of the imminent insolvency. However, in the vicinity of or after the commencement of insolvency, there are overriding considerations, such as the protection or rehabilitation of the debtor and the protection of third party's rights.[8] Insolvency law establishes a protective shield around the debtor from creditor claims.

2.1.1 Contractual freedom and commercial reasonableness

A distressed debtor becomes subject to the principles of insolvency law. These principles have additional considerations, including the rights of third parties such as creditors.[9] However, it should be noted that in contrast to other jurisdictions *ipso facto* clauses, ie termination due to default which may be linked to insolvency, are not prohibited under English law.[10] Even the termination of an individual transaction due to default permits termination of other transactions that are "inextricably linked".[11]

2.1.2 Set-off

Set-off is a legal mechanism whereby mutual claims[12] are aggregated to form a single obligation, reducing the overall gross to a net amount.[13] A solvent party can consequently claim the net obligation in the insolvency proceeding. Set-off can take the form of contractual set-off,[14] insolvency

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7 If the principles of equity are applied, enforcement may vary or be applied only in principle. *Philips Hong Kong Ltd v Attorney-General of Hong Kong* (1993) 9 Const LJ 202 recited Dickson J in the decision of the Supreme Court of Canada in *Elsley v JG Collins Insurance Agencies Ltd* [1978] 2 SCR 916 as follows: "… the power to strike down a penalty clause is a blatant interference with freedom of contracts and is designed for the sole purpose of providing relief against oppression… It has no place where there is no oppression". This suggests that English courts will only interfere as a last resort and seek to protect the sanctity of freedom of contract; however, we will see that interference may be justified on a regulatory level.

8 See Clark J in *BNP Paribas v Wockhardt* [2009] All ER (D) 76 (Dec): provided it does not constitute any void advantage, close-out netting places both counterparties in the same position, as if the transaction continues

9 See section 2.4

10 See Belmont Park Investments Pty Ltd v BNY Corporate Trustee Services Ltd [2009] EWCA Civ 1160; [2010] Ch. 347 (CA (Civ Div)) and Lomas v JFB Firth Rixson Inc [2010] EWHC 3372 (Ch) (Ch D (Companies Ct)) discussed in Roy Goode, 'Flip clauses: the end of the affair?' (2012) 128(Apr) Law Quarterly Review p. 171

11 See *Bombay Official Assignee v Shroff* [1932] 48 TLR 443

12 The meaning of claims is broad, and includes claims that are present or future, and certain or contingent, see Pascal Pichonnaz and Louise Gulllifer, *Set-off in arbitration and commercial transactions* (Oxford University Press 2014) p. 293. In this context, contingent claims are claims that cannot be ascertained in advance. For instance, an indemnity provision could give rise to a claim, which could form part of a set-off arrangement. This scope has been adopted for the purposes of claims that could be subject to resolution measures, and causes significant practical problems

13 Set-off distinguishes between natural and legal persons. The former are governed by section 323 of the Insolvency Act 1986 and the latter by rr 14.24 and 14.25 of the Insolvency Rules 2016

14 Parties to a contract are free to contract as long as the provisions do not infringe mandatory requirements. Close-out netting, as will be seen below, is also often associated with this principle. However, interaction with insolvency law, which is such a mandatory requirement, casts some doubt on whether close-out netting may just depend on contractual freedom or whether it is in fact intended as a

set-off and equitable set-off. The underlying policy motivation is "that it would be unjust to allow a party to enforce his money claim without giving credit for the cross-claim".[15] Courts have reaffirmed the importance of set-off by stating that its application is mandatory and that any contravening provision or a provision altering its effect is void.[16] The inherent equitable jurisdiction of courts does not permit disapplying set-off. In particular, insolvency law's policy rationale takes into account that

> where parties have been giving to each other in reliance on their ability to secure payment by withholding what is due from them it would be unjust… to deprive the solvent party of his security by compelling him to pay what he owes in full and be left to prove for his own claim.[17]

In other words, the intention of set-off is "to do substantial justice".[18] The benefit of set-off is that unsecured creditors obtain a claim with a value equivalent to their obligation, i.e. a pound for a pound instead of a claim for diluted dividends. Set-off hinges on the presumption that the assertion of certain transactions but not others would be inequitable given their interconnectedness.[19] It follows that simultaneous enforcement of the linked transaction is a requirement. The flawed asset provision is based on this principle. It stipulates that entering into new transactions is premised on the fact that existing obligations are honoured. In other words, there is a legitimate reliance on the continuance of trade. Overall, set-off provides some certainty to market participants.

2.1.2.1 Operation of set-off

Set-off is a bilateral right that not only benefits the debtor. It also reduces the number of claims and obligations that can be enforced by a liquidator or administrator. The application of set-off is mandatory,[20] automatic and self-executing.[21] Thus, it does not require the assistance of the parties or a third party, such as the liquidator or administrator. The mandatory character also applies to any new transactions concluded after the declaration of insolvency or to individual transactions within the claw-back period, unless prohibited by the relevant administrator. Insolvency set-off is a mechanism governed by mandatory law, in the presence of mutual debts and in the absence of notice of the imminent or actual insolvency.[22] In fact, any contractual agreement that may frustrate the operation of the mandatory statutory provisions is unenforceable. The relevant rules are set out

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result of policy deliberations. See Vanessa Finch, *Corporate Insolvency Law* (2nd edn, Cambridge University Press 2009) p. 601

15 Louise Gullifer, *Goode on Legal Problems of Credit and Security* (5th edn, Sweet & Maxwell 2013), p. 283. Therefore, it is not permitted to contract out of insolvency set-off, see *National Westminster Bank Ltd v Halesowen Presswork & Assemblies Ltd* [1972] AC 785 . However, contractual provisions which limit or restrict contractual set-off do not conflict with public policy and can be enforced, see *Coca-Cola Financial Corporation v Finsat International Ltd* [1996] 3 WLR and *BOC Group plc v Centeon LLC* [1999] 1 All ER (Comm) 53

16 Although in Re Maxwell Communications Corp Plc (No.2) [1993] 1 W.L.R. 1402 and Re SSSL Realisation (2002) Ltd [2006] EWCA Civ 7 it was found that it is possible to contract out of the pari pasu principle, provided the arrangement does not result in divestiture of the insolvency debtor's assets

17 Louise Gullifer, *Goode on Legal Problems of Credit and Security* (5th edn, Sweet & Maxwell 2013), p. 284

18 Francis Morales, 'Insolvency set-off: "The mutuality of assignment in subordination"' (2015) Corporate Rescue and Insolvency p. 187

19 *Aectra Refining Inc v Exmar NV* [1994] 1 WLR 1634, 1649 per Hoffmann LJ

20 See *MS Fashions Ltd v Bank of Credit and Commerce International SA (No 2)* [1993] Ch 425, 432-3 per Lord Hoffmann

21 *National Westminster Bank Ltd v Halesowen Presswork & Assemblies Ltd* [1972] AC 785

22 *Stein v Blake* [1996] 1 AC 243s per Lord Hoffmann

in r 14.24 (in liquidation) and r 14.25 (in administration) of the Insolvency Rules 2016.[23] Lord Hoffmann construes the provisions as follows

> When the conditions of the rule are satisfied, a set-off is treated as having taken place automatically on the bankruptcy date. The original claims are extinguished, and only the net balance remains owing one way or the other: *Stein v Blake.* The effect is to allow the debt which the insolvent company owes to the creditor to be used as security for its debt to him. The creditor is exposed to insolvency risk only for a net balance.

It should be added that this rule operates bilaterally, i.e. upon insolvency the net amount may constitute either an obligation or claim for the non-defaulting party. In effect, it helps the liquidator or administrator to ascertain the overall claim and obligations. Application requires the satisfaction of specific requirements.

2.1.2.2 Requirements

The application of statutory set-off requires satisfaction of specific requirements, which ensure that the assets and obligations to be set off meet the policy justification. The primary requirements include mutuality and connectedness, which will be discussed in the following.

(a) The requirement of mutuality

The application of set-off requires that there is a close connection between assets, liabilities and obligations. This requirement applies both to statutory set-off[24] and netting, both pre[25]- and post[26]-insolvency. In English law, this precondition is referred to as mutuality of parties. In contrast, civil law jurisdictions require mutuality of claims.[27] This relative broader notion under English law demonstrates the normative reason for and more benign approach to set-off and netting. The policy rationale of mutuality is to prevent using one party's assets to offset claims between a third party and its creditors. As long as it can be asserted that the claims exist between both parties, they will qualify for set-off. In addition, there is equitable set-off, which lies within the inherent jurisdiction of

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23 Similarly, insolvency rules that were introduced after the financial crisis in relation to financial institutions contain similar provisions. In relation to bank insolvency: r 72 of the Bank Insolvency (England and Wales) Rules 2009. In relation to bank administration:14.24 as applied by the Bank Administration (England and Wales) Rules 2009. In relation to investment bank special administration: r 164 of the Investment Bank Special Administration (England and Wales) Rules 2011. In relation to a special administration (bank insolvency) or a special administration (bank administration): r 164 as applied by r 165 of the Investment Bank Special Administration (England and Wales) Rules 2011

24 *Ince Hall Rolling Mills Co Ltd v The Dougals Forge Company* [1882] 8 QBD 179, *Re Steel, Iron and Coal Co* [1894] 38 SJ 252 Cr. See also Francis Moraes, 'Insolvency set-off: "The mutuality of assignment in subordination"' (2014) Corporate Rescue and Insolvency p. 187

25 *Muscat v Smith* [2003] EWCA Civ 962, paras. 42 to 45 per Buxton LJ

26 It might be argued that the precondition is more pronounced in post-insolvency stages; see Rory Derham, 'Equitable set-off: A critique of *Muscat v Smith*' (2006) 122 LQ. The civil law approach entails a somewhat artificial separation of claims that qualify for aggregation. For this purpose, counterparties must assert that cross-claims exist under the master agreement, and not at the level of each transaction. Consequently, the risk is that set-off or netting arrangements fail due to lack of mutuality. Similarly, the number of claims is more restricted. In practice, it would entail recourse to local set-off rules, since local courts disregard the agreement in their analysis or analogise close-out netting to set-off. For this purpose, a court ascertains a claim or obligation for each transaction. Given that the courts may disregard the contractual master agreement in its entirety or apply statutory provisions to determine the value of the claims or obligations, see Schuyler Henderson, *Henderson on Derivatives* (LexisNexis, 2009) p. 406

27 Pascal Pichonnaz and Louise Gulllifer, *Set-off in arbitration and commercial transactions* (Oxford University Press 2014) pp. 199 sq

the courts.[28] Although it has no strict definition, equitable set-off depends the facts of the case at hand.[29] It requires a close connection between assets, liabilities and obligations to be set-off and not applying set-off would produce an unjust or unfair result.[30] The requirement of mutuality also implies that the claim must be enforceable or crystallised to form part of the cross-claims.[31] Partial termination of transactions can risk that mutuality fails.

(b) The requirement of connectedness

The test of connectednes, which was initially believed that the cross-claim should "impeach" the claim has evolved.[32] This understanding does not provide much guidance. The requirement was subsequently relaxed to the extent that it was thought to be inequitable to enforce claims without recognising the cross-claims.[33] Rix LJ challenged the 'inseparable connection' test in *Geldof* which is now considered the leading authority.[34] He explained that there are two parts to the test.[35] The first element is "close connection", which is the formal element. Close connection is a matter of principle, which refutes that it can be recognised as a matter of discretion.[36] The second element is that it would be inequitable to not recognise cross-claims since the "ultimate rationale of the regime is equity".[37]

2.1.2.3 Contrast with set-off

Böger submits that close-out netting is different from set-off and constitutes an *sui generis* agreement - that is, an "innominate contract".[38] In short, there are substantial differences between set-off and close-out netting. First, close-out netting allows the parties to elect either automatic termination or enforcement upon delivery of a termination notice.[39] In contrast, insolvency set-off is invoked once the administrator intends to make a distribution[40] or upon commencement of the

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28 See *Hanak v Green* [1958] 2 QB 9

29 See Westdeutsche Landesbank Girozentrale v Islington LBC; Kleinwort Benson Ltd v Sandwell BC (aka Islington LBC v Westdeutsche Landesbank Girozentrale) [1994] 1 W.L.R. 938; [1994] 4 All E.R. 890

30 See Rory Derham, 'Equitable set-off: A critique of *Muscat v Smith*' (2006) 122 LQ

31 *Glencore Grain Ltd v Agros Tading Co* [1999] 2 Lloyd's Rep 410, para. 32

32 In other words, call its existence in question *Rawson v Samuel* (1841) Cr. & Ph. 161, 179

33 *Rawson v Samuel* (1841) Cr. & Ph. 161; *Hanak v Green* [1958] 2 QB 9; *The Teno* [1977] 2 Lloyd's Rep 289; *British Anzanni (Felixstowe) Ltd v International Maritime Management (UK) Ltd* [1980] QB 137, see Louise Gullifer, *Goode on Legal Problems of Credit and Security* (5th edn, Sweet & Maxwell 2013), p. 283

34 *Geldof Metaalconstructie NV v Simon Carves Ltd* [2010] EWCA Civ 667 at [43(iii)]

35 See Louise Gullifer, *Goode on Legal Problems of Credit and Security* (5th edn, Sweet & Maxwell 2013), p. 313

36 *Geldof Metaalconstructie NV v Simon Carves Ltd* [2010] EWCA Civ 667 at [43(v)]

37 Ibid

38 Ole Böger, 'Close-out netting provisions in private international law and international insolvency law (Part I)' 18(2) Uniform Law Review p. 232, p. 235, referring to Ian Annetts and Edward Murray, 'Set-Off, Netting and Alternatives to Security' in Dan Prentice and Arad Reisberg (eds) *Corporate Finance Law in the UK and EU* (Oxford University Press 2011) p. 269, p. 277; Marc Benzler, *Nettingvereinbarungen im ausserbörslichen Derivatehandel* (Nomos 1999) p. 56; Jan Dalhuisen, *Transnational Comparative, Commercial, Financial and Trade Law* (4th edn, Hart 2010) Volume 3, p. 345, p. 347; Simon Firth, *Derivatives Law and Practice* (Sweet & Maxwell 2008) paras. 5-024; Roy Goode, Principles of Corporate Insolvency Law (4th edn, Sweet & Maxwell 2011) paras. 9-09

39 While parties are free to elect whether automatic enforcement or enforcement by notice will apply, certain jurisdictions require automatic termination, since close-out netting rights cannot be exercised after commencement of the relevant insolvency proceedings or reorganisation measure

40 R 14.24(1) of the Insolvency Rules 2016

liquidation procedure[41]. It can be inferred that close-out netting provides more certainty as regards the parties' ability to terminate, which allows the non-defaulting party to conclude a replacement transaction with another solvent financial institution.

Second, the valuation of financial contracts, when terminated prematurely, is a highly sophisticated exercise and needs to be contract-specific.[42] If it involves obligations that are denominated in different currencies, the target currency, conversion time and exchange rate are substantial considerations.[43] Yeowart and Parsons therefore argue that "[t]his could produce a *radically* different result".[44] Recent experience has shown that this is a real risk.[45] In light of this, Yeowart and Parsons suggest that the Insolvency Rules 2016 "should be disapplied" if there is a close-out netting arrangement in place because close-out will ensure the proper functioning of the risk management mechanisms of the solvent institution.[46] Given that the right to invoke close-out netting can, in theory, be withheld permanently, the administrator or liquidator should be able to enforce the arrangements at his discretion.

There is a risk that courts may seek to characterise close-out netting agreements as set-off arrangements. Due to the similarity, a court may argue that the arithmetic operation to obtain a net sum is, in fact, an application of set-off. It may be submitted that the overall, aggregate commercial value needs to be considered. Moreover, the flaw provisions stress that the parties always deem their transactions as a single transaction and that failure to perform on one transaction affects all transactions. Thus, at any point in time, there is only a single net balance due. This supports the argumentation that close-out netting cannot contravene the cosequence of set-off in insolvency. In this context, it is worth reiterating

The crucial difference lies in the recognition of cross-claims. Set-off recognises the existence of cross-claims, whereas close-out netting operates on the presumption that there is only a single claim. Set-off only allows application to monetary obligations, i.e. physically settled obligations or transaction which envisage a certain performance cannot be included in the set-off arrangement. Close-out netting provides for the valuation of transactions, thereby converting obligations to monetary claims.[47] Still, set-off paved the way for close-out netting. Contractual close-out netting agreements should be distinguished from set-off. Set-off remains relevant in relation to unpaid

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41 If the liquidation procedure is commenced or the administrator notifies his intention to make a distribution according to the Insolvency Rules 2016, before the non-defaulting counterparty has delivered an enforcement notice, statutory set-off pursuant to r 14.25(1) of the Insolvency Rules 2016 is applied

42 However, it resolves problems pertinent to set-off, such as when the underlying obligations are non-monetary values, see Emily Sanderson, 'Special delivery: The impact of close-out netting on delivery obligations' (2013) Journal of International Banking and Financial Law p. 149

43 Geoffrey Yeowart and Robin Parsons, *Yeowart and Parsons on the Law of Financial* Collateral (Elgar Financial Law and Practice 2016) p. 229, for further technical differences between insolvency set-off and close-out netting

44 Geoffrey Yeowart and Robin Parsons, *Yeowart and Parsons on the Law of Financial* Collateral (Elgar Financial Law and Practice 2016) p. 233 (emphasis added)

45 In the Lehman Brothers International (Europe) administration, the administrator filed a 2.95 notice under the Insolvency Rules on 4 December 2009, while a vast amount of financial contracts remained open

46 Geoffrey Yeowart and Robin Parsons, *Yeowart and Parsons on the Law of Financial* Collateral (Elgar Financial Law and Practice 2016) p. 234

47 English courts have taken a benign view of physically settled transactions

amounts and collateral arrangments invovling security interest must be set off against the close-out amount of the ISDA master agreement.

2.2 Benefits for financial institutions and stability

As indicated above, close-out netting has benefits for the institution employing the mechanism as well as for financial stability overall. The following subsection seeks to analyse the arguments from a reasoned and pragmatic point of view, since an economic analysis is outside the purview of this thesis.

2.2.1 The regulation of credit mitigation techniques prior to the financial crisis

The primary support for close-out netting arrangements is based on the argument that it is an integral contractual risk management mechanism against credit risk.[48] In 1997, the head of the Banking and Financial Establishment Division of the European Commission wrote:[49]

> Nobody disputes the risk-reducing effect of netting agreements in over-the-counter (OTC) derivative contracts. There is an evident interest for banking supervisors to promote such agreements in order to improve the soundness of banks.

It is alleged that the argument has been accepted without assessing the real merits:

> public policy makers found it easy to be positively disposed towards the [International Swaps and Derivatives Association] … as it appeared to offer a credible mechanism through which the OTC derivatives industry could be efficiently self-regulated.[50]

Hitherto it has been impossible to balance the benefits and risks of close-out netting in an empirically defensible manner. Relevant studies indicate significant reductions in credit risk on a micro-prudential level, which, by implication, should also reduce risk on a macro-prudential level as indicated by Philipp Paech. [51] This suggests that public policy justifies the enforceability of the mechanism. This view has been assessed by Philipp Paech, who argues that, in addition to the abovementioned micro-prudential benefits, further benefits includes increasing liquidity. In fact, Paech reinstuted the legal discussion about the relevance of credit risk mitigation techniques and market liquidity in Europe. His analysis scrutinises the Financial Collateral Directive.[52] David Mengle first quantified the reduction of risk and the concurrent release of collateral for economically and

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48 International Derivatives and Swaps Association, *Benefits of Close-out Netting of Derivative Transactions* (June 2016), available at http://assets.isda.org/media/db2b424a/4301aea7-pdf/ <accessed 22 April 2018>

49 Paolo Clarotti, 'EU Directives and their Impact on Netting' (1997) 5(2) Journal of Financial Regulation and Compliance p. 154

50 John Biggins, "'Targeted Touchdown' and 'Partial Lift-off': Post-Crisis Dispute Resolution in the OTC Derivatives Markets and the Challenge for ISDA" (2012) 13(12) German Law Journal p. 1297, p. 1310

51 See Philipp Paech, 'Repo and derivatives portfolios between insolvency and regulation' (2017) LSE Law, Society and Economy Working Papers 13/2017, Philipp Paech, 'Systemic risk, regulatory powers and insolvency law – the need for an international instrument on the private law framework for netting' (2010) Institute for Law and Finance Working Paper Series No. 116, Philipp Paech, 'The value of financial market insolvency safe harbours' (2016) 36(4) Oxford Journal of Legal Studies p. 855. See also Francisco Garcimartín, "Derivatives in Cross-border Insolvency Proceedings" in Dennis Faber and Niels Vermut (eds) *Bank Failure: Lessons from Lehman Brothers* (Oxford University Press 2017) para. 14.04

52 Philipp Paech, 'The Value of Financial Market Insolvency Safe Harbours' (2016) 36(4) Oxford Journal of Legal Studies p. 855; for a discussion on the Financial Collateral Directive see section 3.2

socially beneficial use.[53] This conjecture is widely supported by policymakers.[54] Mokal contends, however, that the perceived increase in liquidity is merely superficial, and lacks substantial underpinning. He claims that privileges "exponentiate froth".[55] The outcome is overvaluation and abundance of assets and addverse behavioural implications, nurturing an uncertain economic environment prone to financial crises.[56]

For financial institutions, two notable benefits result from the management of credit risk. First, increased risk management allows the financial institution to benefit from regulatory capital relief and reduction of collateral.[57] Second, the potential for loss following the counterparties' default is minimised as are uncertainties inherent in insolvency proceedings and restructuring measures. These advantages can benefit the economy at large.[58] However, the benefits are not confined to insolvency situations. When taking a pre-insolvency perspective, the availability of the exemption can lower the cost of hedging.[59] The availability of close-out netting arrangements and the resulting regulatory capital relief releases capital, which becomes available for economically beneficial purposes.[60] Furthermore, it has been reported to increase the liquidity of financial instruments used for hedging, thereby reducing the cost of protection for financial institutions and other market participants.[61]

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53 See David Mengle, 'The economic role of speculation' (2010) 4 International Derivatives and Swaps Association, Research Notes No. 2

54 Financial Stability Board, Key Attributes of Effective Resolution Regimes for Financial Institutions (2011 as amended in 2014), KA No. 4 and Annex V, available at http://www.fsb.org/what-we-do/policy-development/effective-resolution-regimes-andpolicies/, and Cross-border Bank Resolution Group of the Basel Committee on Banking Supervision, Report and Recommendations of the Cross-border Resolution Group (2010)

55 Rizwaan Mokal, 'Liquidity, Systemic Risk, and the Bankruptcy Treatment of Financial Contracts' (2015) 10(1) Brooklyn Journal of Corporate, Financial & Commercial Law p. 9

56 See section 4.3.2

57 Regulatory capital means the capital which is a regulatory requirement and serves to ensure the viability of the financial institution and reduce any risks arising from its default, see Graeme Baber, 'Legislative Comment Basel III implementation and the European Union: the proposed Capital Requirements Directive (CRD IV)' (2012) 33(11) Company Lawyer 341 and Graeme Baber, 'Legislative Comment: Basel III implementation and the European Union: the proposed Capital Requirements Regulation (CRR)' (2012) 33(12) Company Lawyer p. 386 The amount of collateral is calculated net of exposure, see Paul Harding and Christian Johnson, *Mastering the ISDA Collateral Documents: A Practical Guide for Negotiators* (2nd edn, Financial Times Prentice, 2011)

58 Philipp Paech, 'Systemic Risk, Regulatory Powers and Insolvency Law – The Need for an International Instrument on the Private Law Framework for Netting' (2010) Frankfurt University, Institute for Law and Finance Working Paper Series No 116, 13; the European Central Bank ("ECB") demonstrated, in light of the experience of the financial crisis, that close-out netting was essential for the prevention of contagion, i.e. the risk that failure of one market participant spreads to another, see European Central Bank, *Report on the Lessons Learned from the Financial Crisis with Regard to the Functioning of the European Market Infrastructures* (April 2010)

59 Franklin Edwards and Edward Morrison, 'Derivatives and the Bankruptcy Code: Why the Special Treatment?' (2005) 22 Yale Journal on Regulation p. 102, p. 104 and Philipp Paech, 'Systemic Risk, Regulatory Powers and Insolvency Law – The Need for an International Instrument on the Private Law Framework for Netting' (2010) Frankfurt University, Institute for Law and Finance Working Paper Series No 116, 15

60 Philipp Paech, 'Systemic Risk, Regulatory Powers and Insolvency Law – The Need for an International Instrument on the Private Law Framework for Netting' (2010) Frankfurt University, Institute for Law and Finance Working Paper Series No 116, p. 15

61 See Robert Bliss and George Kaufman, 'Derivatives and Systemic Risk: Netting, Collateral, and Closeout' (2006) 2(1) Journal of Financial Stability p.55, p. 68

2.2.2 The regulation of credit mitigation techniques after the financial crisis

Financial institutions use close-out netting arrangements for credit risk management purposes. Close-out reduces the notional aggregate to the real risk exposure of a certain counterparty – and thus better reflects the expected loss in case of its default.[62] Intuitively, the same applies on an aggregate level in relation to the financial institution's exposure to financial contracts. For the counterparty, close-out has the advantage of reducing the related credit support and thereby improving access to financial contracts.

After the financial crisis of 2007, legislators have been seeking to establish a regime to reduce the risks inherent in the OTC derivatives markets. It follows the G20 mandate[63] to *inter alia* clear all eligible transactions through central counterparties.[64] As the caveat that only "eligible transactions" should be cleared suggests that not every transaction can be cleared. Consequently, the regime provides for further measures that can be apposed to risk mitigation to that of cleared derivatives.[65] The respective standards, taking the form of Risk Mitigation Regulatory Technical Standards ("Risk Mitigation RTS"),[66] were developed by the European Supervisory Authorities.[67] These standards require the posting of collateral in the form of Initial Margin ("IM") and Variation Margin ("VM"). The RTS prescribe not only the method to calculate IM,[68] but also the eligible margin to ensure that the assets can be realised in a timely manner, thus preventing re-use or re-hypothecation, and do not incur another risk, such as credit, market or FX risk. Importantly, if deposited with a custodian, the collateral must be strictly segregated.

Appropriate procedures include collateral and capital requirements, other procedures[69] to measure, monitor and mitigate risk, as well as marking-to-market. Evidently, netting and collateral are preconditions. For instance, financial counterparties and certain non-financial counterparties with

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62 There are various measures to calculate credit risk internally. For instance, Expected Loss at Default ("EAD") and Credit Value at Risk ("CVaR") are common internal risk metrics. They estimate the total risk arising from exposure to a counterparty by providing a single number that reflects that with a certain level of confidence the expected losses will not exceed a specific amount. Two methodologies make it possible to estimate these metrics. First, CreditMetrics, by estimating a probability distribution of credit losses by carrying out a Monte Carlo simulation of credit rating changes of the counterparties. Each simulation trial determines the credit rating changes and risk of default during a specified period. Many trials yield the probability distribution for credit losses. Second, the Gaussian Copula model of time to default is used by regulators to calculate capital requirements. This metric attempts to quantify the correlation of defaults of different counterparties. Both metrics show that exposure or expected loss is zero when combined with collateral. See John Hull, *Options, Futures, and Other Derivatives* (10th edn, Prentice-Hall 2017) and John Hull, *Risk management and financial institutions* (5th edn, Wiley 2018).

63 G20 leaders summit in Pittsburgh on 26 September 2009 and in Toronto on June 2010

64 Regulation (EU) 648/2012 (the European Market Infrastructure Regulation or "EMIR")

65 Art 11 EMIR. Risk Mitigation RTS primarily apply to EU financial counterparties and NFCs which have a sizable position in OTC derivatives. Entities in third states fall within its scope if the transactions have a 'direct, substantial and foreseeable' effect within the EU. Alternatively, authorities have the right to assert jurisdiction if it is 'necessary or appropriate to prevent the evasion of any provision' of EMIR. If the EU entity is subject to margin requirements, the third state entity is likely to have to abide by the mutual obligation prescribed by the RTS. See OTC Question 12(b) of the EMIR Q&As on p. 29, available at https://www.esma.europa.eu/sites/default/files/library/esma70-1861941480-52_qa_on_emir_implementation.pdf <accessed on 21 April 2018>

66 Regulation (EU) 2016/2251 of 4 October 2016

67 The European Supervisory Authorities consist of the European Securities and Markets Authority, European Banking Authority and European Insurance and Occupational Pensions Authority. See Art 11(15) of EMIR

68 Standardised Method set out in Annex IV to the Risk Mitigation RTS or by using an initial margin model

69 The Risk Mitigation RTS stipulate that the EU counterparty must have 'robust risk management procedures'. See Recital (38) of EMIR

significant OTC derivative operations are required to 'have risk-management procedures that require the timely, accurate and appropriately segregated exchange of collateral'.[70] In fact, collateral must be exchanged.[71] Overall, these measures serve the systemic risk-reducing goal of EMIR.[72]

The above shows the importance ascribed to close-out netting and collateral in mitigating credit risk for the institution and safeguarding financial stability. This insight, however, is not the product of the financial crisis. Legislators and regulators have come to realise the merits of close-out netting and collateral and have been promoting these measures in light of their interlinkage with financial stability. This interlinkage is discussed in the next subsection.

2.3 Risks and challenges

Close-out netting has been criticised from various angles. At the outset, it should be noted that although economic arguments for and against close-out netting have been presented, empirical studies are rare and questionable.[73] Although arguments challenging even the legitimacy of credit risk mitigation techniques are undoubtedly intuitive and persuasive, an examination reveals the fallacy of the studies' premises. For instance, a formal empirical analysis of the implications for hedging arrangements was conducted by Patrick Bolton and Martin Oehmke.[74] The authors submit that the consequence of the exemptions is transfer of credit risk to other creditors of the counterparty. They argue that the exemptions are solely efficient if the cross-netting arrangement is beneficial for counterparties providing hedging services. This insight complements the general understanding of the benefits of exemptions that they merely reduce hedging cost for parties to the netting arrangement. However, this cost is re-assigned to third parties.[75] Bolton and Oehmke argue that this redistribution of risk does not constitute a cost efficiency and therefore the merits are negligible. This argument's fallacy is consequence of the presumption that the close-out netting results in a disposition of assets. Thereby, the general body of creditors bears the costs of the default. It should be noted that credit risk mitigation does not result in a disposition or facilitate the re-allocation of costs among creditors. Any such attempt is unenforceable and void.[76] Nor do close-out netting arrangements extract value to the detriment of the general body of creditors, as will be elaborated below.

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70 Art 11(3) of EMIR

71 Art 2 of the Risk Mitigation RTS. There are a few exemptions if netting is not enforceable in a third state jurisdiction, i.e. if creditors have recourse to margin posted or it cannot be ensured that collected margin can be enforced in a timely manner without being subject to legal challenge, see Art 31 of the Risk Mitigation RTS, see Stephanie Loizou, 'The new Margin Rules: an overview' (2017) 32(2) Journal of International Banking Law and Regulation p. 67

72 Recital (1) of EMIR and Recital (10) of the Risk Mitigation RTS

73 See International Swaps and Derivatives Association, *The Importance of Close-out Netting* (2010) ISDA Research Notes No 1, p. 2, prepared by David Mengle, presenting evidence that overall credit risk exposure in relation to OTC derivatives markets is reduced by over 85 per cent due to the use of credit risk mitigation techniques. Yet, it may be submitted that due to to the fact that the study was commissioned by ISDA the results may be biased. Regulatory reports prepared by the Bank for International Settlement report equal findings, as will be discussed further below

74 Patrick Bolton and Martin Oehmke, 'Should Derivatives Be Privileged in Bankruptcy?' (2015) 70(6) Journal of Finance p. 2353

75 Patrick Bolton and Martin Oehmke, 'Should Derivatives Be Privileged in Bankruptcy?' (2015) 70(6) Journal of Finance p. 2353, p. 2355

76 See section 2.4.2.2

Rizwaan Mokal[77] and Vincent Johnson[78] offer the most comprehensive academic challenges,[79] which will be explored in the following. It should be pointed out for the purposes of fairness and caution that the said authors wrote without reference to English law and financial institution resolution but from a theoretical and US law perspective. Although informative and representing excellent legal analyses, from an English law perspective the merits of their analysis are questionable as insolvency law mitigates implications. Thus, it is germane to discuss the risks and benefits in the context of a legal framework and of the regulatory environment.

2.3.1 Increase in the risk profile

Financial contracts represent sizeable obligations for financial institutions. It may be inferred that these instruments pose considerable risks by implication. Such conjecture fails to recognise that, if used adequately, they form the basis for financial institutions to operate. These instruments are for financial institutions constitute essential contracts and therefore akin to utilities such as light and water. To reiterate, financial conracts are used for liquidity and risk management, which is at the very core of financial and credit intermediation. They promote the resilience and the viability of financial institutions. Thus, although they can create exposure by realising investment decisions, they can considerably shape the risk profile by reducing risk. In other words, financial contracts can serve to mitigate exposure to undesirable volatility and risk.

Credit risk mitigation techniques reduce credit risk and contagion, thereby promoting systemic stability. However, this benefit has never been further examined in the legislative process. Thus, legislation merely hinges on the presumption that close-out netting promotes systemic stability. The legislative development does not seem to reflect the real benefits of close-out netting, which is primarily an instrument developed by market participants to manage the credit risk of counterparties.

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77 Rizwaan Mokal, 'Liquidity, Systemic Risk, and the Bankruptcy Treatment of Financial Contracts' (2015) 10(1) Brooklyn Journal of Corporate, Financial & Commercial Law p. 9

78 Vincent Johnson, 'International financial law: The case against close-out netting' (2015) 33 Boston University International Law Journal p. 101

79 See also Franklin Edwards and Edward Morrison, 'Derivatives and the Bankruptcy Code: Why the Special Treatment?' (2005) 22 Yale Journal on Regulation p. 91, p. 101; Stephen Lubben, 'Repeal the Safe Harbors' (2010) 18 American Bankruptcy Institute Law Review p. 319, p. 334; Mark Roe, 'The Derivatives Market's Payment Priorities as Financial Crisis Accelerator' (2011) 63 Stanford Law Review p. 539, p. 587; David Skeel, 'Bankruptcy Boundary Games' (2009) 4 Brooklyn Journal of Corporate, Financial and Commercial Law p. 1, p. 19; David Skeel and Thomas Jackson, 'Transaction Consistency and the New Finance in Bankruptcy' (2012) 112 Columbia Law Review p. 152, p. 187; Robert Bliss and George Kaufman, 'Derivatives and systemic risk: Netting, collateral, and closeout' (2005) Federal Reserve Bank of Chicago WP 2005-03; Stephen Lubben, 'The bankruptcy code without safe harbors' (2010) 84 American Bankruptcy Law Journal p. 123; Mark Roe, 'The derivatives market's payment priorities as financial crisis accelerator' (2011) 63 Stanford Law Review p. 539; David Skeel, Jr and Thomas Jackson, 'Transaction consistency and the new finance in bankruptcy' (2012) 112 Columbia Law Review p. 152; Edward Janger, 'Arbitraging systemic risk: system definition, risk definition, systemic interaction, and the problem of asymmetric treatment' (2014) 92 Texas Law Review; Edward Morrison, Mark Roe and Christopher Sontchi, 'Rolling back the repo safe harbors' (2014) 69 Business Lawyer 1015; Steven Schwarcz and Ori Sharon, 'The bankruptcy law safe harbor for derivatives: A path dependence analysis' (2014) 71 Washington and Lee Law Review p. 1715; Steven Schwarcz, 'Derivatives and collateral: Balancing remedies and systemic risk' (2015) 2015(2) University of Illinois Law Review p. 699 and Adam Levitin, 'Prioritization and Mutualization: Clearinghouses and the redundancy of the bankruptcy safe harbors' (2015) 10(1) Brooklyn Journal of Corporate, Financial & Commercial Law p. 9, p. 129. While Levitin challenges the need to carve out close-out netting provisions from insolvency law with a view to the evolving clearing framework, he fails to appreciate the the fact that close-out netting forms an essential part of the framework and that not all financial contracts must or can be cleared.

2.3.2 Frustration of the rehabilitation of the distressed debtor

During the financial crisis of 2007, it transpired that the enforcement of credit risk mitigation techniques might frustrate the recovery or resolution of distressed financial institutions.[80] The reason is that the very intervention to rescue an institution can trigger early termination – and thereby loss of the ability to manage risk and liquidity. Moreover, margin calls require that additional collateral be posted.[81] When a financial institution experiences distress, maintenance of liquidity and risk management measures is crucial.

Enforcement of collateral may also cause valuable assets to evaporate. This does not equally apply to all financial contracts. It should be pointed out that securities financing transactions affect the exchange of assets. Thus, equal value is received in return. In contrast, collateral posted in the context of financial derivatives serves to secure contingent obligations. No exchange of real, tangible assets occurs. Hence, securities financing transactions do not contribute to the loss of assets. However, deterioration of financial standing or adverse changes of collateral may cause margin calls. Overreliance on securities financing transactions to manage liquidity can be problematic if insufficient liquidity is held due to the following reason. If the financial position deteriorates, it may become impossible to find new counterparties to rebalance its risk profile. For instance, it may be impossible to "lend" securities to procure liquidity. Consequently, the assets must be sold, which can reduce the asset value – thereby increasing the losses.

2.3.3 Prejudicial to the general body of creditors

A popular belief is that close-out netting alters the creditor insolvency hierarchy under insolvency law. Close-out netting arrangements benefit creditors to the detriment of fellow creditors providing super-seniority. The reason is the false presumption that the claims contained in the close-out arrangements are satisfied before more senior claims. Thus, close-out netting upsets the insolvency law hierarchy and is prejudicial to the general body of creditors. Following this rationale, the general body of creditors is liable to incur losses, since they receive worse treatment to the extent they are not subject to similar arrangements. In short, close-out netting facilitates "prejudicial dispositions". As seen above in relation to the anti-deprivation principle, it is impossible to contract out of insolvency law. Courts are astute in identifying and invalidating "sham devices" but also "innocent" transactions that are prejudicial to other creditors under the rules of avoidance. It suffices to state that transactions effected in contravention of statutory provisions within a suspect period will be clawed back, i.e. the transaction will be reversed or the non-defaulting party must restitute the debtor.

It may be submitted that whereas legal rights are not directly affected, the economic reality is. Close-out netting may reduce the available unsecured claims before any secured claims are satisfied.[82]

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80 DG Markt/G2, Close-out netting initiative roadmap (2011) version no. and Barbara Attinger, 'Crisis management and bank resolution quo vadis, Europe?' (2011) ECB Legal Working Paper Series No 13 p. 12

81 See the decision in *Goldman Sachs International v Videocon Global Ltd* [2013] EWHC 2843 (Comm) (QBD (Comm)) which confirmed that multiple margin calls can be submitted

82 If the parties are acting at arm's length, ie in their own intrest and wihtout undue influence or knowledge of the actual or impending insolvency of the counterparty, it should not give raise to preference under the voidance rules

The effect is therefore reduction of the debtor's distributable assets.[83] However, the amount of assets is not reduced. Application of close-out netting does not result in an immediate payment obligation. A counterparty is a secured creditor in regard to the collateralised amount. Hence, application of the collateral against the close-out amount does not violate insolvency law. A counterparty is, however, an unsecured counterparty for the uncollaterised amount. Such debt must be proved and will be discharged by the administrator or liquidator in accordance with insolvency law.

Similarly, it has been suggested that close-out netting represents an unwritten security interest since claims are reduced before other unsecured creditor claims are satisfied.[84] This suggestion is not new,[85] and has not lost its appeal. Its rationale is that close-out reduces the loss from a gross to a net amount; hence, the economic effect is the same as security. In contrast to security, close-out netting does not require registration or other perfection requirements. However, the principal feature distinguising security is the absence of proprietary interest in the debtor's assets.[86] Set-off between the parties is the manifest principle which stipulates that mutual claims need to be applied against each other.

2.3.4 Reduction of the value of the debtor's estate

Close-out netting can reduce existing claims of the debtor. It thereby reduces the value of the claims that could benefit the debtor, which reduces the probability of successful rehabilitation. It is useful to reiterate the relevance of this perspective in order to understand the regulation of such an event. As with the different legal traditions across jurisdictions, the perspective of relevant protection and to which parties it is accorded differs. For instance, jurisdictions with a more debtor-centric perspective, such as continental Europe and to a lesser extent the United States of America, have the primary objective of rescuing distressed entities. It may be doubted whether this objective is relevant in regard to financial institutions.[87] Overall, the English legal tradition can be described as creditor-centric. Under this perspective, creditor interests are given priority. Enforcing certain claims while concurrently repudiating obligations would inevitably result in an inequitable outcome for creditors.

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83 See Lucian Bebchuk and Jesse Fried, 'The Uneasy Case for the Priority of Secured Claims in Bankruptcy' (1996) 105 Yale Law Journal p. 857, p. 903

84 Vanessa Finch, 'Security, Insolvency and Risk: Who Pays the Price?' (1999) 62 Modern Law Review p. 633 and Vanessa Finch, *Corporate Insolvency Law: Perspectives and Principles* (2nd edn, Cambridge University Press 2009)

85 See *Re Washington Diamond Mining Co* [1893] 3 Ch 95, 104 per Vaughan Williams J; and *Stein v Blake* [1996] 1 AC 243, 251 per Lord Hoffman

86 *Electro-Magnetic (S) Ltd v Development Bank of Singapore Ltd* [1994] SLR 734 and see Pascal Pichonnaz and Louise Gulllifer, *Set-off in arbitration and commercial transactions* (Oxford University Press 2014) p. 299; and Roy Goode, *Principles of Corporate Insolvency* (2nd edn, Sweet & Maxwell 2011) para. 9-01

87 See section 4.1; see also Schuyler Henderson, *Henderson on Derivatives* (LexisNexis, 2009) para. 11.3; these debtor-friendly jurisdictions require the continuation of executory contracts that benefit the debtor, while ensuring the performance of substantive obligations. Although as an equitable principle, the administrator should respect that the various contracts constitute a single contract pursuant to the single-agreement clause under the common master agreements, he may nevertheless seek to enforce certain transactions, thereby impairing the enforceability of the master agreements. A counterparty experiences uncertainty with respect to the balancing of its risk, since sudden termination by the administrator can result in re-transferral of risk

Conversely, it is believed that giving credit to mutual debts leads to a more just outcome for debtor and creditor.[88]

2.4 English insolvency law, rules and principles

There seems to be no apparent argument that could support a restriction for close-out netting, outside resolution. Under English law, if parties act in a commercially reasonable manner, there are no prohibitions to terminate and net transactions . Individuals are free to contract that either party will have a claim upon the occurrence of a specified event subject to the general principles of contract law. The ability to close out outside of insolvency merely amounts to "methods for putting [the counterparty] into the same position it would have been in if the contract had not been validly terminated" and it does not provide for "an extravagant or unconscionable measure".[89] Each position has a certain value, and "conversion" into a single net claim does not "confiscate" any assets. In other words, no value is removed from the debtor's estate; the counterparty must prove its claim as an unsecured creditor and is subject to the distributional procedure and insolvency hierarchy.

This subsection analyses any conflicts with insolvency laws and principles as a result of the application of close-out netting. Insolvency law mitigates the arguments on risks, inefficiencies and purported deterioration that ensue upon the enforcement of credit risk mitigation arrangements advanced in academic literature. Before analysing insolvency law, it should be pointed out that insolvency is not a mechanism overriding the validity of contracts and offending the general principle of (contract) law. The primary purpose of insolvency law is to ensure adequate protection of legitimate interests of creditors and debtors. Thus, only actions that undermine this primary objective shall be restricted. This restriction must be ascertainable to promote legal certainty; arbitrary laws canthe right to property under the Convention Rights.[90] As will be discussed, various fallacies regarding guiding principles may misinform academics, practitioners and even courts. Insolvency law promotes the protection of creditors.

2.4.1 Proceedings

In general literature, insolvency is perceived as consisting of three different procedures, namely liquidation, administration, and voluntary arrangements. In reality, however, insolvency "is a body of law that is greater than the sum of those parts".[91] There are the following broad categories that can be instuted against a distressed institution depending on the degree of distress and ability the rehabilitate it: liquidation, winding-up,[92] reorganisation, composition and rehabilitation proceedings.[93]

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88 See Roy Goode, *Principles of Corporate Insolvency Law* (2nd edn, Sweet & Maxwell 1997) pp. 172 to 203

89 *BNP Paribas v Wockhardt* [2009] All ER (D) 76 per Clark J

90 Art 1 of Protocol 1 of the European Convention on Human Rights as implemented by the Human Rights Act 1998

91 Hamish Anderson, *The Framework of Corporate Insolvency Law* (Oxford University Press 2017) p. 2

92 Although commonly used synonymously with liquidation, winding-up proceedings are not necessarily related to insolvency. They can be initiated to voluntarily discontinue an undertaking on the basis of a special resolution of its shareholders or otherwise. This serves the realisation of profits. Otherwise the court has discretionary power to order compulsory winding-up proceedings, see *Re Surrey Garden Village Trust Ltd* [1965] and *Re Cade & Sons Ltd* [1992]

93 Dermot Turing, 'Clearing and Settlement in Europe' (2012) Bloomsbury Professional. This list was expanded in the aftermath of the financial crisis of 2007 with bank insolvency, bank administration,

Gullifer and Payne classify these proceedings as those that are 'statutory compromises', whereby solutions to distress are devised amongst management and creditors on a consensual basis, [94] and formal insolvency proceedings which are more intrusive and require the involvement of courts and an insolvency practitioner.[95] Under the Companies Act 2006, a creditors' scheme of arrangements can be established, which belongs in the former category.[96] All other measures are encompassed in the Insolvency Act 1986 and the Insolvency Rules 2016. Financial institutions were and can be subject to the Insolvency Act 1986 if incorporated under the Companies Act 2006 or its predecessors. However, modifications have been made which can be applied under certain circumstances, as explored further below.

In addition, public bodies[97] can be subject to a *sui generis* regime and certain private companies to a modified regime, as discussed below.[98] This difference in application of regimes follows from the need to accomodate the different objectives of entities, stakeholders and potential ramifications that can result from insolvency. Certain features relating to private companies that are subject to a special resolution regime, such as utility and transport companies, should be noted.[99] Thus, there are special considerations that warrant special treatment so as to allow the continuation of certain essential services, most noticeably if the company operates in a monopoly or oligopoly and the service is of public interest. Deposit-taking, credit intermediation and the provision of investment services were initially not considered to merit a special regime. General insolvency law was applied in relation to financial institutions in only a few cases.[100] The following will discuss the main proceedings under English insolvency law.

2.4.1.1 Commencement

The Insolvency Act 1986 does not define the term 'insolvency'. Instead, it uses the concept of a company being 'unable to pay its debts'.[101] This entails that the court is satisfied that the company is unable to pay its debts as they fall due, i.e. the cash flow insolvency test, and that the value of the

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investment bank special administration and special administration (bank administration) as well as pre-insolvency recovery and resolution procedures

94 Whilst voluntary in nature, creditors can be bound by the decision of the majority. It should be noted that, in contrast to formal proceedings, there are no measures which could affect the ability to exercise close-out netting rights; however, the proceeding limits the ability to make claims

95 Louise Gullifer and Jennifer Payne, *Corporate Finance Law* (2nd edn, Hart Publishing 2015) and Vanessa Finch, *Corporate Insolvency Law: Perspective and Principles* (Cambridge University Press 2009)

96 Section 895 of the Companies Act 2009

97 It is evident that conventional insolvency proceedings are inadequate to resolve public bodies, seeing that conventional proceedings seek to maximise and distribute insolvency dividends, whereas public bodies serve a vital function that is of public interest. Thus, the relevant proceedings must seek continuation of that function

98 For a more extensive study on the various special administration procedures in respect of traffic, public-private partnerships, energy, postal services, health care, water supply, payment and settlement systems, and insurance, see Hamish Anderson, 'What is the purpose of insolvency proceedings?' (2016) 8 Journal of Business Law p. 670

99 For instance the special administration procedures under the Energy Act 2004 and the Railway Act 1993, respectively. See Sarah Paterson, 'Chapter 7: Banking Act Restructuring and Insolvency Procedures' in Rodrigo Olivares-Caminal, Alan Kronberg, Sarah Paterson, John Douglas, Randall Guynn and Dalvinder Singh (eds) *Debt Restructuring* (2nd edn, Oxford University Press 2016) ("Debt Restructuring") para. 7.01.

100 For instance, Bank of Credit and Commerce International SA in June 1990 and group entities of Baring plc such as asset managers in February 1995, see Debt Restructuring (n 99) para. 7.02

101 Section 123 of the Insolvency Act 1986

company's assets is less than that of its liabilities, i.e. the balance sheet test.[102] In the context of financial institutions, the cash flow test plays a crucial role and is a better indicator than the balance sheet test, since financial institutions are commonly highly leveraged and can survive irrespective of whether their liabilities exceed their assets. In contrast, the inability to pay (i.e. illiquidity) almost certainly precipitates insolvency.[103] Master agreements do not merely use this as an indication of default but consider it an actual event of default.[104] Moreover, financial institutions must maintain regulatory capital.[105] Exhaustion of the buffers and the inability to replenish them may result in revocation of the banking licences.

2.4.1.2 Liquidation

The primary objective of the liquidation procedure is to ascertain the debtor's claims and arrange the distribution insolvency dividends amongst its creditors, thereby liquidating the debtor. If the institution is insolvent, a creditor's petition for a court order will instigate the proceeding.[106] In case of financial institutions, the right to petition is reserved for the Bank of England ("BoE"). The court appoints a liquidator,[107] who will realise the claims and distribute them amongst the creditors, who will prove their claims in accordance with the insolvency hierarchy discussed below. It suffices to state that there are preferential, secured and unsecured creditors. Preferential creditors enjoy a priority over other creditors due to their nature.[108] Secured creditors may enforce their security pre- and, to a limited extent, post-insolvency. Once liquidation has commenced, all legal proceedings and rights will be stayed.

2.4.1.3 Administration

In contrast to liquidation, administration has a more reflective set of objectives dependent on the degree of distress of the entity. Under the hierarchy of objectives, the primary objective is to rehabilitate the distressed entity so as to allow it to continue operating as a going concern.[109] As a secondary objective, the administrator must maximise the value of the debtor in order to satisfy

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102 Another test is that the company has not paid a claim for a sum due to a creditor exceeding GBP 750 within three weeks of having been served notice for repayment, i.e. a statutory demand; and the execution or judgment against the company is unsatisfied. In *BNY Corporate Trustee Services Ltd v Eurosail UK 2007-3BL plc* [2013] UKSC 28 the Supreme Court held that the balance sheet test and the cash flow test should be viewed together.

103 Simon Gleeson and Randall Guynn, *Bank Resolution and Crisis Management; Law and Practice* (Oxford University Press 2016) pp. 88 sq. The cash flow test does not consider the liabilities, either accrued, contingent or prospective, thereby failing to recognise that "[i]t is not sufficient for the company to be able to meet its current obligations if its total liabilities can ultimately be met only by the realisation of its assets and these are insufficient for the purpose", see Roy Goode, *Principles of Corporate Insolvency Law (3rd edn, Sweet & Maxwell 2005*) p. 88. Since financial institutions are highly leveraged, their ability to refinance their debt should be considered, especially in times of distress, see liquidity coverage ratio, see Regulation 2015/61

104 See *TMT Asia Ltd v Marine Trade SA* [2011] EWHC 1327 (Comm)

105 See section 3.1

106 Section 122 of the Insolvency Act 1986; this compulsory liquidation can be distinguished from voluntary liquidation, instigated by a resolution of the general meeting, see section 84 of the Insolvency Act 1986

107 Section 143 of the Insolvency Act 1986

108 Employees, as regards certain unpaid wages and social security benefits are preferential creditors in most liquidations

109 See Schedule 16 to the Enterprise Act 2002 and section 3(1) of Schedule B 1 to the Insolvency Act 1986

creditor claims. The third objective is to distribute the dividends to the debtor's creditors in accordance with their ranking in the insolvency hierarchy.[110]

2.4.2 Principles

The above procedures and measures are underpinned and complemented by guiding insolvency law principles. Such principles have originated from repealed insolvency laws or have been developed by courts alongside the statute. These principles aim to guide the insolvency practitioner and provide for priority and control, as set out in *Worseley v Demattos*,[111] which is crucial for achieving the Insolvency Act's objective.[112] English insolvency law contains principles which are widely recognised and form *mutatis mutandis* part of the insolvency laws of other Member States, such as *pari passu* and the conservation principle. The following two subsections discuss the role of the *pari passu* and anti-deprivation principles in insolvency. Although both principles represent normatively defensible and appealing underpinning values for insolvency proceedings and restructuring measures, their real role is often overstated. Since close-out netting arrangements impair their operation, it has been alleged that close-out netting offends insolvency law. Due to the falsely ascribed sanctity of the principles, critical academic literature advocates restricting the validity and enforceability of close-out netting agreements. In some jurisdictions, this may be appropriate; however, placed in the English law context, there is little value in the argumentation. The primary aim of this subsection is therefore to challenge the attributed value of the principles and to contrast their effect with the purported benefits of close-out netting.

It should be recalled that the principles under the Insolvency Act and Insolvency Rules 2016 apply to all companies irrespective of their legal form and operations. It therefore needs to be analysed whether the principles can be applied *mutatis mutandis* to financial institutions and whether there should be overriding objectives such as financial stability and modified principles – as will be done in the following chapters.

2.4.2.1 *Pari passu* principle

The *pari passu* principle is the subject of a vivid academic discussion and seems to misinform not only academics and practicioners, but somewhat worryingly also judges and legislators.[113] It is a common misunderstanding that the principle protects creditors by ensuring uniform treatment of unsecured creditors. Not rarely has the *pari passu* principle been attributed universal validity. This presumption is, however, flawed. For instance, European legislation does not contain any provision that recognises and gives effect to *pari passu.*[114] Nor does English law corroborate this conjecture.

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110 Sections 143 and 305 of the Insolvency Act, and see Roy Goode, *Principles of Corporate Insolvency Law* (4th edn, Sweet & Maxwell 2011) para. 2-01

111 *Worseley v Demattos* (1758) 1 Burr 467 KB at 476 per Lord Mansfield

112 "Rules of priority concern the substantive question of how the estate is to be divided; and the rules of control concern the procedural question of who manages, realises and distributes the debtor's estate", see Reinhard Bork and Martin Voelker, 'The anti-deprivation rule as an anti-avoidance rule' (2016) 29(5) Insolvency Intelligence p. 65

113 See Lachlan Burn, 'Pari passu clauses: English law after NML v Argentina' (2013) 9(1) Capital Markets Law Journal 2; Benjamin Chabot and Mitu Gulati, 'Santa Anna and his Black Eagle: the origins of pari passu?' (2014) 9(3) Capital Markets Law Journal p. 216; and Cheng-Yun Tsang, 'Ex-Im Bank v Grenada: adding clarity or confusion?'(2015) 10 (2) Capital Markets Law Journal p. 142

114 Case T-79/13 *Alessandro Accorinti and Others v European Central Bank*, para. 99

Despite the appealing normative value of this argumentation,[115] it is faulty, as will be discussed below.

(a) Meaning

As discussed by Look Chan Ho[116] and Rizwaan Mokal[117], *pari passu* can be ascribed two meanings. According to the first and more orthodox understanding, *pari passu* requires treating creditors in accordance with their pre-insolvency entitlements. This follows from an interpretation of section 107 of the Insolvency Act 1986 and related r 14.12 of the Insolvency Rules 2016. Hence, any distributions should be made in accordance with pre-insolvency entitlements. The second understanding concerns the priority of creditors' insolvency,[118] which guides the "procedural steps within an insolvency proceeding or … the distribution process".[119] The second meaning ascribed to *pari passu* entails process for a *pro rata* distribution. This means that all creditors within the same class must receive equal dividends for their claims. It has been submitted that section 175(2)(a) of the Insolvency Act 1986 challenges this understanding since it specifies the treatment of preferential claims. Davies, reflecting on Ho and Mokal, submits that this section "paradoxically… can be seen as an exception to the 'orthodox *pari passu* principle' and as an application of the *pari passu* principle, when that term is used in the second sense".[120]

The above suggests the following. Although several commentators understand that the *pari passu* principle constitutes a central element in insolvency law, its actual role is less clear. The understanding is premised on the fallacy that the principle promotes a "normatively defensible" distribution.[121] *British Eagle* has been often falsely used to challenge this principle; however, the reason or the judgement in the lack of mutuality.[122] This is also suggested by the absence of an express provision ascribing *pari passu* a central role in English insolvency law. Quite to the contrary, as Paulus reports, "the history of bankruptcy legislation could even be delineated as a never-ending fight for privileges", and equal treatment is unlikely to form part of insolvency law.[123] And courts are prepared to depart from this principle of equal treatment.[124] This misinterpretation of the principle[125] complicates administration procedures and can be a major obstacle when exercising resolution measures, as will be seen below

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115 Vanessa Finch, 'Security, insolvency and risk' (1999) 62 Modern Law Review p. 633

116 Look Chan Ho, 'The principle against divestiture and the *pari passu* fallacy' (2010) 1 Journal of International Banking and Financial Law p. 3

117 Rizwaan Mokal, 'Prioriy as pathology: The *pari passu* myth' (2001) 60 Cambridge Law Journal p. 581

118 See Rizwaan Mokal, *Corporate Insolvency Law: Theory and Application* (Oxford University Press 2005) and Look Chan Ho, 'Review Article: Goode's Swan Song to Corporate Insolvency Law' (2006) 17(6) European Business Law Review p. 1727, pp. 1735–17544

119 Christoph Paulus, 'The Wonderful World of Privileges' (2014) 4 European Company and Financial Law Review p. 531, p. 533

120 James Davies, 'The nature and scope of the anti-deprivation rule in the English law of corporate insolvency – part one' (2011) 8(2) International Corporate Rescue p. 155, p. 156

121 Rizwaan Mokal, 'Liquidity, Systemic Risk, and the Bankruptcy Treatment of Financial Contracts' (2015) 10(1) Brooklyn Journal of Corporate, Financial & Commercial Law p. 9

122 See footnote 138

123 Christoph Paulus, 'The Wonderful World of Privileges' (2014) 4 European Company and Financial Law Review p. 531, p. 533

124 See Adam Gallagher and Jack Shepherd, 'Express Electrical Distributions: Sparking new life back into the pari passu principle' (2017) 14(1) International Corporate Rescue p. 36

125 See Roy Goode, *Principles of Corporate Insolvency Law* (2nd edn, Sweet & Maxwell 1997) p. 182

(b) Criticism

It is submitted that the scope of the *pari passu* principle needs to be construed narrowly. *Fraser v Oystertec*[126] is the often-mentioned authority supporting that the application of *pari passu* is mandatory and cannot be defeated by contract. Arguably, this understanding follows from the failure to distinguish *pari passu* from the anti-deprivation principle.[127] Another fallacy is that *pari passu* promotes priority in distribution not within but across different creditor classes.[128] This will be rebutted in the following subsection.

(c) Re-interpretation

It should be noted that set-off is enshrined in the Insolvency Rules 2016, whereas *pari passu* does not have statutory footing and is rarely invoked or mentioned in case law. In fact, its application is limited.[129] In light of the case law, Mokal asserts that the objective and the better understanding of the *pari passu* principle is that creditors within a creditor class should receive the same treatment within and not across creditor classes.[130]

A role often ascribed to the *pari passu* principle is that it prevents creditors from seeking to withdraw their funds in expectation of a potential default. Due to the falsely perceived role of equal treatment, the *pari passu* principle is believed to disincentivise creditors from engaging in such adverse behaviour.[131] However, Mokal argues that "ensuring that creditors take their place in the queue is one thing. The order in which they line up is, in general, quite another".[132] Thus, *pari passu* cannot alone effect change in behaviour. Similarly, netting of all the transactions under one master agreement cannot alone deprive the general body of creditors of insolvency dividends.

2.4.2.2 Anti-deprivation principle

Another principle considered to serve a crucial function in insolvency law is the principle of conservation, also known as the anti-deprivation principle, which has also often been falsely subsumed under *pari passu*.[133] Not rarely has this principle been falsely qualified as a rule. As discussed in the following, this understanding is deeply flawed, not least due to the lack of definition and objective of this principle. As a result, the principle is often conflated with other principles, such as *pari passu*,[134] thereby giving the latter a broader meaning and effect in literature and, somewhat unsettlingly, in case law.

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126 *Fraser v Oystertec* [2003] EWHC 2787 (Ch)

127 This principle will be discussed in the following subsection, including the *Fraser* case and its implications

128 Look Chan Ho, 'The principle against divesture and the *pari passu* fallacy' (2010) 1 Journal of International Banking and Financial Law p. 4 ("Ho")

129 This point is further analysed in section 2.4.2

130 Rizwaan Mokal, 'Priority as Pathology: The Pari Passu Myth' (2001) 60(3) The Cambridge Law Journal pp 581

131 Ibid

132 Ibid

133 Ho (n 99), see James Davies, 'The nature and scope of the anti-deprivation rule in the English law of corporate insolvency – part one' (2011) 8(2) International Corporate Rescue p. 155, p. 155

134 See Sarah Worthington, 'Making sense of arguments about the anti-deprivation rule' (2011) 8(1) International Corporate Rescue p. 27

(a) Meaning

As a principle which has been attributed rule-like features, the anti-deprivation principle suffers from significant deficiencies. "[T]he courts and commentators alike have struggled to elicit from case law a coherent principle with well-defined limits."[135] It was held that in *Ex p Jay* that[136]

> "a simple stipulation that, upon a man's becoming bankrupt, that which was his property up to the date of the bankruptcy should go over to someone else and be taken away from his creditors, is void as being a violation of the policy of the bankrupt law."

In fact, recent case law revealed the inherent uncertainties in relation to the nature and extent of the anti-deprivation principle.[137] The source of confusion is the decision in *British Eagle*,[138] which suggests that assets which were ascertained by the insolvency practitioner must be distributed without discrimination amongst unsecured creditors. The reasoning concerned a contractual set-off arrangement amongst various parties, which was not enforced by the court. An application of insolvency set-off has certain preconditions such as mutuality of debts or dealings, and these preconditions are not satisfied in multi-party arrangements. A more persuasive interpretation of the decision is, therefore, that contractual arrangements cannot defeat statutory provisions. In this sense, the reference to *pari passu* in *British Eagle* prescribes that the distribution to creditors should be made according to legislation.[139] Due to the lack of mutuality, the preconditions for set-off were not met and therefore the arrangement failed.

Unsurprisingly, the meaning of the anti-deprivation principle required revision when it was applied to the Lehman litigation.[140] The current academic understanding is as follows. According to Goode, the anti-deprivation principle has the objective of "[avoiding] a reduction in the net asset value of the company to the detriment of other creditors at the point of winding up".[141] It seeks to protect the assets of the distressed company and does not relate to the priority in distribution. In other words, whereas *pari passu* distribution has no implications for the net asset value of the firm, the anti-deprivation principle serves to limit arrangements reducing the debtor's estate. On balance, the conservation of assets serves the rehabilitation of the distressed company permitting it to continue operating as a going concern or, if not possible, maximisation of the dividends payable to creditors.

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135 See James Davies, 'The nature and scope of the anti-deprivation rule in the English law of corporate insolvency – part one' (2011) 8(2) International Corporate Rescue p. 155, p. 155

136 See *Ex p Jay* (1880) 14 Ch D 19, 25. The decision was motivated by the decision in *Whitemore* where Sir William Page Wood V-C stated: '... the law is too clearly settled to admit of a shadow of doubt that no person possessed of property can reserve that property to himself until he shall become bankrupt, and then provide that, in the event of his becoming bankrupt, it shall pass to another and not to his creditors' *(Whitemore v Mason* (1861) 2 J & H 204 at 212)

137 See *Perpetual Trustee Co Ltd v BNY Corporate Trustee Services Ltd* [2009] EWCA Civ 1160

138 British Eagle International Air Lines Ltd v Cie Nationale Air France [1975] 1 W.L.R. 758; [1975] 2 Lloyd's Rep. 43 HL

139 The decision has been often criticised in subsequent case law, for instance in *Belmont Park* [2012] 1 A.C. 383, and in academia, see Rizwaan Jameel Mokal, 'Priority as pathology: The pari passu myth' (2001) 60(3) Cambridge Law Journal p. 581 and Rizwaan Mokal, 'At the intersection of property and insolvency: The insolvent company's encumbered assets' (2008) 20 Singapore Academy of Law Journal p. 495, pp. 527 to 28

140 See Rachel Cole, 'Anti-deprivation: a rule of 'purgatorial complexity?' (2011) 5 Corporate Rescue and Insolvency p. 149

141 See Roy Goode, *Principles of Corporate Insolvency Law* (3rd edn., Sweet & Maxwell 2005) para. 7-04 ("Goode"); see Lord Neuberger MR in *Perpetual Trustee Co Ltd v BNY Corporate Trustee Services Ltd* [2009] EWCA Civ 1160, at para. 50

It will be seen that the anti-deprivation principle is less relevant in the context of financial institutions and resolution; instead, it is argued that other objectives override and replace it.

In contrast to the *pari passu* principle, the primary objective of the anti-deprivation principle is to assist the rehabilitation of the distressed entity by restricting the disposition of assets. The satisfaction of creditors' claims does not form part of it. Only, once it is evident that the distressed entity cannot be rehabilitated, the conservation principle applies. The latter's purpose is to seek to maximise the value of the debtor in order to satisfy creditor claims. However, as could be be seen during the financial crisis, close-out netting can preclude an orderly recovery of the distressed institution. Nevertheless, since the anti-deprivation principle is incapable of operating pre-insolvency, it cannot be infringed.[142] It shall be noted that recovery measures can provide for more suitable solutions – which do not require application of this principle.

(b) Criticism

Fraser v Oystertec is often advanced as an objection to the legitimacy of close-out netting arrangements. The decision in that case suggests that the application of set-off before insolvency is invalid as it reduces the value of the estate. The decision was predicated on the assumption that application of the conservation principle can also precede the commencement of insolvency. It is unsurprising that this principle is the most critical of close-out netting. As consequence, the decision remains one of the most cited sources. However, Fraser is not considered good law and was subsequently overturned by *Perpetual Trustee.*[143] In *Perpetual Trustee*, it was held that the anti-deprivation principle could not be applied pre-insolvency.[144] The Supreme Court reaffirmed this decision in *Belmont Park Investments.*[145] The latter's decision clarified that deliberate intent to deprive the estate of assets is required. In unclear circumstances, "a commercially sensible transaction concluded in good faith should not be held to infringe the anti-deprivation principle".[146] And where a debtor has performed its obligation, the anti-deprivation principle protects the *quid pro quo* notion.[147] Hence, transactions concluded in good faith cannot be invalidated.

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142 Joanne Windsor and Paul Sidle, 'The anti-deprivation rule and insolvency linked termination rights post Belmont: where are we now?' (2011) 8 Journal of International Banking and Financial Law p. 451

143 *Perpetual Trustee Co Ltd v BNY Corporate Trustee Services Ltd* [2009] EWCA Civ 1160 (on appeal from [2009] EWHC 1912 (Ch)). *Perpetual* was a joint appeal that arose from the Lehman Brothers insolvency and Woolworth administration in 2008

144 A divergence between US and English law is evident in this case. The bankruptcy courts of the Southern District of New York held that the flip clauses altering the seniority of creditors are void, see *Re Lehman Brothers Holdings Inc* 422 BR 407 (SDNY, 2010). In contrast, the Court of Appeal and High Court enforced the contractual provision as it served a legitimate *bona fide* commercial interest and was not intended to defeat the purpose of insolvency law or deprive either the debtor or the general body of creditors assets, see Sarah Worthington, 'Good faith, flawed assets and the emasculation of the UK anti-deprivation rule' (2012) 75(1) The Modern Law Review p. 78.

145 Belmont Park Investments PTY Limited v BNY Corporate Trustee Services Limited and Lehman Brothers Special Financing Inc [2011] UKSC 38; see for a criticism of this decision Richard Calnan, 'Anti-deprivation: a missed opportunity' (2011) 9 Journal of International Banking and Financial Law p. 531 and Nick Gavin-Brown, 'Belmont Park Investments and the anti-deprivation principle: wider implications?' (2011) 9 Journal of International Banking and Financial Law p. 574

146 See Sarah Worthington, 'Good Faith, Flawed Assets and the Emasculation of the UK Anti-Deprivation Rule' (2012) 75(1) Modern Law Review p 112

147 Sarah Worthington, 'The Scope and application of the anti-deprivation rule' in Dennis Faber and Niels Vermunt (eds) *Bank Failure: Lessons from Lehman Brothers* (Oxford University Press 2017) paras. 11.1 sq and Simon Whittaker, 'Kicking around the anti-deprivation principle' (2012) 5 Corporate Rescue and Insolvency p. 193, p. 194

The importance attributed to the above principles varies enormously amongst jurisdictions. Given the predominance of US critical scholarship, it can be inferred that the critical approach towards close-out netting finds its source in US law. In contrast to English law, US law enshrined the prohibition of *ipso facto* clauses in its Bankruptcy Code, thereby prohibiting the termination or modification of contracts merely due to insolvency.[148] The underlying policy motivation is that such clauses are akin to penalties for failure.[149] Under the US approach, the strong presumption of *ipso facto* needs to be rebutted – by satisfying certain preconditions and benefiting from "safe harbour" protection.[150] Ascribing global validity to the *ipso facto* clause prohibition, however, is misleading.

In contrast, English law does permit *ipso facto* clauses, provided they are commercially sensible andare at arm's length. Neither legislation nor any authority prohibits termination due to actual or impending default. In fact, forcing a creditor to continue while it is unclear whether the debtor will continue to honour its obligations is considered unjust. In particular, termination or the acceleration of obligations allows the realisation of costs for services rendered. Overall, application of set-off or close-out netting ensures a just departure from the commercial relationship. However, certain contracts are deemed essential, and the Insolvency Act 1986 expressly provides that these may not be terminated – provided that the debtor continues honouring its obligations. Thus, while the *ipso facto* clauses prohibition constitutes a catch-all provision, the English regime is more targeted. Hence, the English regime requires no safe harbour carving out credit risk mitigation techniques from mandatory insolvency stays. Collateral which has been posted can be realised to discharge the owned obligation. It does not contravene the anti-deprivation rule since the debtor ceased to have beneficial right to the assets. [151] However, it is impossible to call new collateral due to an increase in the value of the underlying obligtions. A consequence of this conclusion is a reversal of the burden of proof from defending credit risk mitigation techniques to presenting academically sound arguments against their enforcement.

(c) Re-interpretation

Briggs J suggests disregarding the anti-deprivation rule in order to promote commercial and contractual certainty. For instance, in the case of *Lomas,* he claimed that, in light of the "countervailing public policy in favour of contractual certainty and party autonomy in bona fide

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148 See Ravi Suchak, 'Corporate rescue proceedings and the enforcement of *ipso facto* termination clauses: A comparison of the English and US approaches' (2011) 8(2) International Corporate Rescue p. 131 Joanne Windsor and Paul Sidle, 'The anti-deprivation rule and insolvency linked termination rights post Belmont: where are we now?' (2011) 8 Journal of International Banking and Financial Law p. 451

149 See section 365(e)(1) of the US Bankruptcy Code, which governs the rehabilitation proceedings applied to distressed business in the United States

150 See Craig Enochs, James Pappenfus, Andrea Pincus and Paul Turner, 'Swap agreement safe harbors at risk in latest Lehman dispute' (2015) 16(2) Journal of Investment Compliance p. 52; Stephen Moller, Anthony Nolan and Howard Goldwasser, 'section 2(a)(iii) of the ISDA master agreement and emerging swaps jurisprudence in the shadow of Lehman Brothers' (2011) 26(7) Journal of International Banking Law and Regulation p. 313; Peter Marchetti, 'Amending the Flaws in the Safe Harbors of the Bankruptcy Code: Guarding against Systemic Risk in the Financial Markets and Adding Stability to the System' (2015) 31(2) Emory Bankruptcy Developments Journal p. 305 and Stacey Steele, 'The Collapse of Lehman Brothers and Derivative Disputes: The Relevance of Bankruptcy Cultures to Roles for Courts and Attitudes of Judges' (2014) 30 Law in Context: A Socio-Legal Journal p. 51

151 Richard Calnan, *Proprietary Rights and Insolvency* (Oxford University Press 2010) para. 1-22

commercial arrangements", application of the anti-deprivation rule should be restricted.[152] He submitted that the concluded derivative transactions served as a hedge, thereby reasoning that continued performance on the side of Lehman was crucial, which coincides with ISDA's position when acting as *amicus curiae.*[153]

Early termination of the transaction can result in a windfall payment. It begs the question to which questions the extent to windfall payments can be considered punitive. The law on penalties is the most likely challenge to set-off pre-insolvency.[154] The law limits payments resulting from a breach to amounts which represent a genuine pre-estimate of loss incurred as a result of the breach. Excessive payments that should serve to deter a breach will be deemed void and will be unenforceable.

In this context, Goode refers to the early decision in *Money Markets Ltd v London Stock Exchange Ltd*:[155]

> [i]t is not possible to discern a coherent rule, or even an entirely coherent set of rules, to enable one to assess in any particular case whether such a provision (a 'deprivation provision') falls foul of the principle … and perhaps not surprisingly, it is not entirely easy to reconcile the conclusions, and indeed the reasoning, in some of the cases.

Subsequent case law examined this question. For instance, in *Lomas v JFB Firth Rixson Ltd*[156] it was held that

> [t]he modern trend has been to restrict rather than to broaden the ambit of the application of the rule, for two reasons. The first is that, in a corporate context, the increasingly sophisticated anti-avoidance provisions now in the Insolvency Act 1986 […] reduce the need for a general anti-avoidance principle originally developed to protect the much simpler bankruptcy legislation from evasion.

With regard to dissolution clauses, Goode reports that the interest to be determined upon liquidation by the solvent firm does not constitute a deprivation of the insolvent firm; *ex ante* termination does not breach the anti-deprivation rule.[157] English law grants solvent parties the right to terminate limited interest assets if the agreement so stipulates upon insolvency.[158]

2.4.3 Voidable transactions

The rules of avoidance are often disregarded in academic literature.[159] Various potential problems attributed to credit risk mitigation techniques are regulated under these rules. In order to balance

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152 *Lomas v JFB Firth Rixson Inc* [2012] EWCA Civ 419 (03 April 2012) at para. 96; see for a precedent also favouring the parties' commercial interest over substantial law, *British Eagle International Airlines Ltd v Cie Nationale Air France* [1975] 2 All ER 390

153 The use of *amicus curiae* (friends of the court) by English courts in context of banking financial litigation is rare; in contrast, in the US, ISDA has, in various cases, been invited to provide evidence as expert witness, see International Derivatives and Swaps Association, *Amicus Briefs*, available at https://www2.isda.org/functional-areas/legal-and-documentation/amicus-briefs <accessed 23 February 2017>

154 *BNP Paribas v Wockhardt EU Operations (Swiss) AG* [2009] EWHC 3116 (Comm)

155 *Money Markets Ltd v London Stock Exchange Ltd* [2002] 1 WLR 1150, per Neuberger J [117]

156 *Lomas v JFB Firth Rixson Inc* [2010] EWHC 3372 (Ch), per Briggs J at [96]

157 Roy Goode, *Principles of Corporate Insolvency Law* (4th edn, Sweet & Maxwell 2011) pp. 220 sq

158 Ibid

159 The reason is that there are considerable differences in scope, effect and exemptions, see Aurelio Guerrea-Martinez, 'The avoidance of pre-bankruptcy transactions: An economic and comparative approach' available at https://www.iiiglobal.org/sites/default/files/media/AGM%202017.%20The%-20Avoidance%20of%20Pre-Bankruptcy%20Transactions.%20Final_0.pdf <accessed 28 October 2017>

freedom of contract and party autonomy, the rules of avoidance restrict deliberate intentions to subvert or defeat the purpose of insolvency.[160] Moreover, notions surrounding fairness and undue preference to the detriment of other creditors are addressed through these rules. It establishes a framework for ensuring that fundamental principles of English law are respected. Violation of the rules of avoidance can render contracts void and unenforceable or require restitution in case the voidable transaction was effected. A court order for the re-transfer or restitution would be issued against the non-defaulting party.[161] Although there is no express provision protecting an innocent creditor (as will be explored below), the lack of knowledge acts as a defence against any voiding order. Overall, case law suggests that if transactions were entered into at arm's length and in the absence of evidence suggesting that they were entered into to circumvent insolvency law and rules, the courts are likely to recognise and permit the transactions.

2.4.3.1 Penalty or failure to mitigate

The principles of contract law may override contractual arrangements to the extent that they can be deemed to constitute penalties or failures to mitigate.[162] For such principles to apply, the effect of the contractual arrangement must be manifestly incompatible with English public policy.[163] Due to the absence of any precedence regarding the question of whether a contractual arrangement can constitute an offence of contract law that is manifestly incompatible with English public policy, an analogy may illustrate the degree of severity required. Reflecting on *SA Consortium General Textile v Sun & Sand Agencies Ltd*,[164] Dicey et al. argued that

> [w]hether enforcement of a judgment may be refused on the grounds of public policy when the judgement is for exemplary, punitive, or manifestly excessive damages remains undecided… In SA Consortium General Textile v Sun & Sand Agencies Ltd Lord Denning MR considered that there was no such objection at common law, but the element of the overall damages which was allegedly punitive was a modest figure awarded in respect of the manner in which the defendant had exposed the claimant to greater expense by the manner in which he had defended the claim.[165]

Therefore, it is crucial to examine the effect of the amount and purpose of payment. Under the principles of penalty and failure to mitigate, the payment must constitute a "genuine" and "reasonable" estimate of, for instance, the loss that ensues from the breach of contract. Regarding the required severity described in the above quote, the standard provisions of the master agreements cannot invoke public policy grounds. During the financial crisis of 2007, the courts held,

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In the US context, avoidance plays a negligible role. The lack of discussion of its merits is therefore a natural consequence of the predominance of US commentators. An important exemption is Philipp Paech, who reflects on the merits and role of voidable transactions from an English perspective, see Philipp Paech, 'The Value of Financial Market Insolvency Safe Harbours' (2016) 36(4) Oxford Journal of Legal Studies p. 855

160 For an analysis see Hamish Anderson, *The Framework of Corporate Insolvency Law* (Oxford University Press 2017) p. 3 and Sarah Worthington, 'Good Faith, Flawed Assets and the Emasculation of the UK Anti-Deprivation Rule' (2012) 75(1) Modern Law Review p 112

161 Geoffrey Yeowart and Robin Parsons, *Yeowart and Parsons on the Law of Financial* Collateral (Elgar Financial Law and Practice 2016) pp. 100 sq

162 Recent examples include Cavendish Square Holding BV v Talal El Makdessi and ParkingEye Limited v Beavis [2015] UKSC 67; [2015] UKSC 67

163 Edward Attenborough, Gareth Eagles and Adam Wallin, 'The reformulated rule against penalties and its impact on finance documents' (2016) 31(1) Journal of International Banking and Financial Law p. 23

164 *SA Consortium General Textile v Sun & Sand Agencies Ltd* [1978] QB 279

165 Albert Venn Dicey, Lawrence Collins, John Humphrey Carlile Morris, *The conflict of laws* (15th edn, Thomson Sweet & Maxwell 2012) para. 14-157 sq

on various occasions, that the close-out netting arrangements under the master agreements did not constitute penalties or failures to mitigate.[166] Parties can negotiate additional payments and consequences following a default. In former times, parties sought to include walk-away provisions entitling the non-defaulting party to default on its obligation. However, this practice is not possible under English law, as set-off would be invoked. Nor would such provisions be recognised for regulatory capital purposes with the consequence that capital charges are calculated on a gross basis.[167]

2.4.3.2 Transactions at an undervalue

The term "transactions at an undervalue" encompasses those transactions which were disproportionally disadvantageous to the debtor and were concluded within the suspect period. The suspect period starts two years before the commencement of an insolvency procedure or restructuring measure.[168] If a transaction entered into within this period can be deemed a gift, or the consideration is significantly less than the actual worth, the transaction may be redndered void by courts upon application by an insolvency practitioner.[169] With respect to the debtor, the court will examine the following. First, the court will consider whether the creditor concluded the transaction in good faith and whether there were reasonable grounds to believe that the transaction was disproportionate. Second, the court will examine whether the debtor was solvent at the time of concluding the transaction or whether it became insolvent as a result.[170]

2.4.3.3 Preferences

Within six months[171] preceding the commencement of an insolvency proceeding or restructuring measure, any transaction or agreement that might place the creditor, surety or guarantor in a better position in insolvency is susceptible to challenge on the grounds of constituting a preference. Avoidance requires a manifest desire to improve the creditor's position vis-à-vis other creditors.[172] It cannot be merely consequential on a legitimate action.[173] Again, participation of the insolvency

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166 *BNP Paribas v Wockhardt* [2009] All ER (D) 76

167 For capital relief see section 3.1

168 Collateral or margin that is posted to cover an exposure under the transaction does not amount to a transaction at undervalue. Consideration to enter into the transaction, if adequate, is sufficient, see *Re MC Bacon Ltd* [1990] BCC 78. This argument has been subject to criticism, see *Hill v Spread Trustee Company* [2007] 1 WLR 2404 CA and see See Rodrigo Olivares-Caminal, John Douglas, Randall Guynn, Alan Kornberg, Sarah Paterson, Dalvinder Singh, Hilary Stonefrost, *Debt Restructuring* (Oxford University Press 2011) p. 23

169 Section 238 of the Insolvency Act 1986

170 See John Finnerty and Yasseen Gailani, 'Expert evidence to support or challenge loss calculations: How credible is it?' (2015) 9 Journal of International Banking and Financial Law p. 1, John McGrath and Simon Farewell, *'Ensarco v Lehman*: An important guide to the determination of loss' (2015) Journal of International Banking and Financial Law p. 428 and Andrew Savage and Leah Alpren-Waterman, 'Problems in pricing? Mastering Market Quotation under the 1992 ISDA Master Agreement' (2014) Journal of International Banking and Financial Law p. 623 and see *Re Barton Manufacturing Co Ltd* [1998] BCC 827

171 Or two years in case of a connected person such as an affiliate, group entity or employee

172 See *Re Bacon Ltd* [1990] BCC 78

173 Millet J recognised in *Re Bacon Ltd* [1990] that:

> A man is not to be taken as desiring all the necessary consequences of his action. Some consequences may be of advantage to him and be desired by him; others may not affect him and be matters of indifference to him; while still others maybe positively disadvantageous to him and not be desired by him…

practitioner will be required.[174] Courts may also order the re-transfer or release of security as a remedial measure. For this purpose, the court will consider the debtor's solvency at the time the transaction was concluded. Hence, if the debtor did not establish the preference in anticipation of insolvency, courts will not sanction the transaction as a preference. As in the case of the transaction at an undervalue, courts will have to establish that the debtor did not become insolvent as a corollary.

2.4.3.4 Transaction defrauding creditors

Insolvency law allows the court to set aside any transaction it deems to aim at defrauding the general body of creditors.[175] Usually, such a transaction involves placing assets beyond the reach of the general body of creditors. Hence, the transaction is foremost a sham device. The distinction with preference is blurred. In contrast to preference and transaction at undervalue, this kind of sham device is not subject to any time limitation. A court will consider whether the debtor has received sufficient valuable consideration when concluding the transaction and whether the conduct was unconscionable.

2.5 Conclusion

This chapter has illustrated that close-out netting is not prejudicial. Neither the debtors' nor the general body of creditors' assets are confiscated or otherwise affected. In contrast to common misperception, there is no presumption against *ipso facto* clauses in English law. This follows from the sanctity of contracts and absence of contradicting policy arguments. The academic objection is a corollary of relevant US literature and of fallacies related to insolvency law principles. Moreover, it has been shown that *ipso facto* clauses pursue commercially sensible objectives which can be reconciled with English jurisprudence and public policy.

Although legislation has been introduced to explicitly recognise and give effect to close-out netting arrangements,[176] insolvency law enforces these arrangements "as a matter of principles of case law", as recently reaffirmed in *Lomas v JFB Firth Rixson*.[177]

By means of the master agreements, parties seek to establish a long-term contractual relationship. The master agreements govern multiple transactions and include default rules that are as "simple, clear and strict" as possible.[178] These default rules can be enforced without having to resort to adjudication.[179] The aim is to prevent that the relationship is upset by inadequate default rules and to ensure that relational norms are better enforced.[180] The remedies provided by credit risk mitigation

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Thus, proof of desire is insufficient; it must be shown that some "influence" was exercised by the creditor. It was submitted that an alternative test should be that the creditor abused the relative position of the debtor and directed the latter's mind, see *Mark John Wilson, Oxford Pharmaceuticals Limited v Masters International Limited* [2009] EWHC 1753, per Marc Caweson QC

174 Section 239 of the Insolvency Act 1986

175 Section 423 of the Insolvency Act 1986

176 See sections 3.2 and 3.3

177 *Lomas v JFB Firth Rixson Inc* [2012] EWCA Civ 419 (CA). See Ole Böger, 'Close-out netting provisions in private international law and international insolvency law (Part II)' (2013) 18(4) Uniform Law Review p. 532, pp. 533 to 34

178 Jonathan Morgan, Contract Law Minimalism: A Formalist Restatement of Commercial Contract Law (Cambridge University Press 2013) p. xiii

179 Ibid, p. xiv

180 Ibid

techniques more appropiate than the remedial measures under English law.[181] For instance, credit risk mitigation operates in the absence of rules on causation,[182] remoteness[183] and duty to mitigate losses[184] enshrined in English contract law.

Application of certain remedial measures under English law could be detrimental to both parties. Market participants are better able to devise a system that is more apt to identify imminent distress and ensure prompt remedial measures.[185] For instance, the compensatory principle prescribes that only the non-culpable party, i.e. the party not defaulting on its obligation, must be compensated. This conflicts the operation of close-out if the defaulting party has a claim. It can be inferred that close-out netting may produce a more equitable outcome. Moreover, the remedy of injunction could expose the non-defaulting party to market volatility and thus inadvertently give rise to uncertainty.

Contract and statute are not inconsistent; in fact, the master agreements resemble the operation of set-off with modifications to adapt this measure to today's financial markets requirements.[186] If close-out netting were unenforceable, set-off would serve as a default rule. This is predicated on the commencement of liquidation or administration proceedings.[187] Thus, there is uncertainty as to when the net amount may be realised. Set-off also suffers from above-mentioned shortcomings in respect of the valuation of transactions such that not all transaction encompassed in a netting arrangement may be recognised. As a result, it may be impossible to value the net exposure at mark-to-market, which undermines the possibility to cover the exposure with sufficient collateral and may result in additional capital charges.[188]

Enforceable netting arrangements allow financial institutions to calculate exposures on a net basis. Given the enforceability, the resulting net amount may be based on the mark-to-market value of the various transactions in the netting arrangement. Moreover, collateral may be value realised such that the proceeds can be used to dischage the obligations of the defaulting counterparty. A non-defaulting counterparty must prove its claim as an unsecured creditor for any shortfall of collateral. In other words, the value of the collateral must be commensurate with or exceed the value of the net claim.

In conclusion, it can be summarised that close-out netting arrangements do not offend the *pari passu* principle by facilitating payment in the insolvency proceedings or restructuring measures. Nor do creditors subject to a netting arrangement rank above secured creditors. Under close-out netting

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181 Cf. Joanne Braithwaite, 'Standard Form Contracts as Transnational Law: Evidence from the Derivatives Markets' (2012) 75(5) Modern Law Review p. 779, p. 789

182 *The Monarch Steamship v Karlshamns Oljefabrika* [1949] AC 196

183 *Hadley v Baxendale* (1854) 9 Ex Ch 341

184 *Payzu v Saunders* [1919] 2 KB 581

185 Cf. Joanne Braithwaite, 'Standard Form Contracts as Transnational Law: Evidence from the Derivatives Markets' (2012) 75(5) Modern Law Review p. 779, p. 789

186 See Jean Braucher, 'Contract versus contractarianism: The regulatory role of contract law' (1990) 47 Washington Lee Law Review p. 697

187 Below we will see that resolution represents a paradigm shift. Insolvency proceedings may have considerable limitations, which requires the continuation of systemically critical functions. Thus, a distressed financial institution must be split into a part that continues operating as a going concern and a residual institution. Unless safeguards are in place, such separation may result in transactions or collateral becoming orphaned. The possibility of set-off or close-out netting will be considerably undermined since the precondition of mutuality cannot be satisfied

188 See section 3.2

arrangements, transactions are aggregated to a net amount and set off against the value of the collateral. If non-defaulting parties have a claim exceeding the value of the collateral, they must prove the exceeding claim as unsecured creditors. The real value of *pari passu* principle lies in its guidance in distributing dividends to insolvency creditors. It should be recalled that *pari passu* is not a rule, but merely describes what distribution can be reasonably expected within a creditor class

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Chapter 3
EU legislation promoting netting

The objective of this chapter is to elaborate why close-out netting not only plays a crucial role in EU prudential law and the integration of EU financial markets, but has also promoted the competitiveness of EU financial institutions. Close-out netting has contributed to establishing the vital infrastructure for transacting financial contracts and promotes international competitiveness. While the previous chapter and the following chapters predominantly focus on English law, the present chapter will explore EU legislation which promotes and protects the operation and use of credit risk mitigation techniques.[1] Whereas EU regulations have direct effect in England, EU directives require transposition and implementation into the English legal framework.[2] Given that the absence of relevant guidance on the construction of EU law, the approach is legislation-specific. While the discussion on the regulations refers to EU legislation, directives require reflection on implementation and transposition as well as on its content and objective. The recitals of the directive and regulation and the *travaux préparatoires*[3] may assist in the interpretation.[4] Due to these complicating factors, the following sections will discuss EU law and its implementation in parallel.

In accordance with the international standards developed by the Bank for International Settlements ("BIS"), the EU legislator recognises the benefits deriving from close-out netting and collateral for financial stability and risk management of critical financial market infrastructures. Therefore, it comes as no surprise that it actively promotes and protects its use. This supports the argument that credit risk mitigation techniques are widely recognised for their prudential regulatory purposes. The existence of such techniques also improves the credit terms for transacting. At European level, it assists the integration of financial markets. Any third state which has implemented a similar regime can expect to have better access to international financial markets. In fact, similar provisions can be found in other jurisdictions that have implemented the BIS standards. The chapter is structured as follows.

The first section explores the relevant articles of the Capital Requirements Directive. Its objective is to establish a prudential regulatory regime in Europe. Although comprising various provisions on bank funding and liquidity, the vital titles regulate the capital adequacy of financial institutions. It stipulates that when incurring credit risk, financial institutions must allocate capital to absorb potential

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1 Although currently dormant, a legislative initiative was proposed to introduce netting legislation in Europe. It is worthwhile to continue following this development, see Bernadette Muscat, 'Draft proposals for new EU netting provisions: further harmonisation or fragmentation' (2014) Journal of International Banking and Financial Law p. 116

2 See section 3.2

3 For instance, in *Re Lehman Brothers International (Europe) (in administration)* [2012] EWHC 2997 (Ch) the High Court dwelled on the construction of English law giving effect to the Financial Collateral Directive (see section 3.2)

4 Courts must enquire about the purpose and intent (Case C-336/03 *easyCar (UK) Ltd v Office of Fair Trading* [2005] ECR I-1947) and, in certain circumstances, consider the context (Case C-337/82 *St Nikolaus Brennerei und Likörfabrik, Gustav Kniepf-Melde GmbH v Hauptzollamt Krefeld* [1984] ECR 1051). For the purpose of completeness, the court may also consider the principles common to Member States (Case 7/73 *Nold KG v Commission* [1974] ECR 491)

losses. In this context, the risk-reducing effects of close-out netting and collateral are recognised. Simultaneously, it lays down the preconditions for this recognition. This section reflects on the historical background of the CRD IV Framework (as defined below) in order to conceptualise its current provisions. Moreover, the actual capital requirements are discussed, including their benefits and challenges. This enables contextualising the effects of credit risk mitigation techniques.

The second section discusses the Financial Collateral Directive ("FCD"), which expressly reinforces the enforceability of close-out netting and collateral by overriding any national law provisions that ban, restrain, prohibit or delay enforcement. However, in most EU jurisdictions, including England, close-out netting arrangements are enforceable as a general principle of law notwithstanding insolvency. Thus, in particular, the FCD has not instigated any noticeable amendments in this regard, but merely reinforced the principle by codification. Even if the FCD does not apply, for instance if the parties do not exchange collateral or one of the parties is outside the scope of the FCD, close-out netting is enforceable as a matter of English law. With that in mind, it can be argued that these contracts do not have a special status as result of a safe harbour but are enforceable as they do not offend or thwart the operation of other laws.

The third section illustrates the application of close-out netting to financial market infrastructure ("FMI") under the Settlement Finality Directive[5] so as to assess the role it plays for risk management. As an example, the analysis will consider EU legislation which safeguards financial market infrastructures. These infrastructures are critical for financial stability. A failure would have highly detrimental consequences, which may exceed those that can be expected from a failure of the systemically relevant financial institutions combined. Such infrastructures are vital for payment systems and, importantly, for the clearing of derivatives. As will be seen, close-out netting has been pinpointed as an integral part of the protection of these infrastructures.

The fourth section explores the Reorganisation and Winding-up of Credit Institutions Directive. While containing some substantive harmonising provisions, it is, in essence, a conflict-of-laws regime. Its objective is to coordinate winding-up proceedings applied to financial institutions. The provisions ensuring the enforceability of close-out netting will be considered. While briefly going into the background of the Directive, this section provides a critical discussion of its merits.

The last section concludes this chapter. In reflecting on the preceding sections, it underpins the prominent position of close-out netting in Europe. Legislation promoting close-out netting follows international best standards on prudential regulation and risk management. Moreover, the framework underlying close-out netting integrates financial markets and frees otherwise encumbered assets. Against this background, the conclusion reiterates that a reversal of this framework would be detrimental to transactions within Europe and would adversely affect the international competitiveness of EU financial institutions.

[5] Directive 1998/26/EC

3.1 Capital Requirements Directive

It is evident that the capital regulation of financial institutions is a complicated matter. To avoid regulatory arbitrage, i.e. financial institutions incorporating in jurisdictions with lower capital requirements, international standards are required. The Bank for International Settlements has set the global standard with the Basel II and Basel III framework ("Basel Accords"). The Basel Accords comprehensively set out multiple reforms to improve prudential regulation, supervision and risk management. In relation to capital, Basel III suggests introducing higher capital ratios as well as leverage and liquidity coverage requirements, which should ensure that a financial institution incurs debt only to a sustainable amount and has sufficient good quality and liquid capital. In Europe, this is achieved by way of the Capital Requirements Regulation ("CRR")[6] and the Fourth Capital Requirements Directive ("CRD IV Directive" and together with CRR, the "CRD IV Framework").[7] This framework is complemented by a "single rulebook" which promotes harmonisation of the implementation across Europe. It contains, amongst others, specifications on the necessary quality of capital, credit risk, counterparty risk, market risk and operational risk.

3.1.1 Background

On 27 April 1993, the Basel Committee on Banking Supervision published the report "Supervisory Recognition of Netting for Capital Adequacy Purposes".[8] It contained 20 risk management recommendations for buy- and sell-side institutions and four recommendations for legislators, regulators and supervisory authorities. The report was drawn up by a working group formed by buy- and sell-side parties, commentators, lawyers as well as accountants. Although not a regulatory document, the report set the ground for the current risk management practices. The recommendations state, amongst others, that credit exposures should be mark-to-market, i.e. the value should represent the daily replacement values, while the model employed should be consistent over time and take into consideration distressed times. Most importantly, credit exposures should reflect the risk-reducing effect of credit risk mitigation techniques.

In the EU regulatory framework, netting appeared in a number of initiatives.[9] It seems that Directive 96/10/EC amending Directive 89/647/EEC as regards recognition of contractual netting by the competent authorities coined the term "netting agreement" in 1996. This Directive is known as the Netting Directive and introduced the beneficial capital treatment of netting agreements into the Solvency Ratio Directive.[10] Both Directives were repealed, but the policy motivation remained the same. The following subsections discuss the recognition of credit risk mitigation techniques on a conceptual basis.

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6 Regulation No 575/2013 ("CRR") came into effect on 1 January 2014 and replaced the Banking and Investment Firm Prudential Sourcebook ("BIPRU") for financial institutions. BIPRU still applies to investment firms subject to Financial Conduct Authority ("FCA") supervision.

7 Directive 2013/36 ("CRD IV")

8 Available at https://www.bis.org/publ/bcbs11c.htm <accessed on 6 May 2018>, see Tony Shea, 'The Basel Committee Consultative Papers on netting' (1993) 8(8) Journal of International Banking Law p. 314

9 See Bernadette Muscat, 'Draft proposals for new EU netting provisions: further harmonisation or fragmentation?'(2014) 2 Journal of International Banking and Financial Law p. 116

10 Directive 89/647 on a solvency ratio for credit institutions

3.1.2 Capital adequacy

The purpose of regulatory capital is to ensure that a financial institution has sufficient capital to absorb shocks. It avoids that shocks have ramifications that could threaten the viability of the institution. It should come as no surprise that after the financial crisis the regulatory consensus was that the regulatory capital standards should be extensively increased.[11] However, the promotion of capital charges is a relatively benign regulatory approach which promotes financial activity while attempting to mitigate the effects of any harmful events. It is a less intrusive approach than restricting financial institutions' operations and seeks to establish a "cushion" that is commensurate with the risk taken by financial institutions.[12] Consequently, financial institutions that assume more risk will be subject to higher capital charges. The CRR specifies that the regulatory capital should equal at least eight percent of the assumed credit risk. National regulators have the discretion to impose a higher percentage based on the deemed riskiness of the financial institution and its relevance for the domestic financial market.[13]

Since financial contracts constitute risky assets as there is an inherent credit default risk or a risk of a contingent obligation arising, they constitute risk-weighted assets ("RWA") for regulatory capital purposes.[14] Collateral reduces capital charges since its value is taken into consideration in determining the net exposure. Should the financial institution over-collateralise due to internal policy reasons, haircuts or failures to withdraw excess collateral posted, the exposure will increase.

3.1.3 Recognition of credit risk mitigation techniques

The reduction of financial exposure through credit risk mitigation techniques is at the core of CRD IV Framework. These techniques are recognised as reducing risk-weighted exposure, triggering regulatory capital requirements. Basel II.5 explicitly endorsed, for the first time, the recognition of credit risk mitigation techniques. This express endorsement was implemented under Art 90 sq and Annex VIII to the EU Banking Consolidation Directive ("BCD").[15] It is an inevitable requirement that credit risk mitigation techniques can operate despite the commencement of insolvency proceedings

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11 Regulation 648/2012 ("EMIR") imposes extensive collateral requirements on derivatives contracts.

12 See Frank Partnoy, 'Chapter 3: Financial Systems, Crises, and Regulation' in Niamh Moloney, Eilís Ferran and Jennifer Payne (eds) *The Oxford Handbook of Financial Regulation* (1st edn, Oxford University Press 2015) p. 69, p 87

13 National authorities may impose additional requirements on an idiosyncratic basis in accordance with supervisory review and evaluation process ("SREP") pursuant to Article 104 of the CRD IV (which includes provisions for additional capital add-on), see European Banking Authority, *Opinion of the European Banking Authority on the interaction of Pillar 1, Pillar 2 and combined buffer requirements and restrictions on distributions* (2016) EBA/Op/2015/24. Additional measures for deemed macroeconomic risks can be imposed under Article 458 of CRR, see Recital (19) of the CRR and European Banking Authority, *Opinion of the European Banking Authority on measures in accordance with Article 458 Regulation* (EU) No 575/2013 (2017) EBA/Op/2017/04

14 The relevant provisions regarding financial derivatives are set out in Chapter 6 (Counterparty credit risk) of Title III of the CRR. Securities financing transactions are governed by similar provisions under Chapter 4 (Credit risk mitigation) of Title III of the CRR. The close-out netting agreement must satisfy the requirements in Arts 295 and 296 of the CRR. The risk-reducing effect is recognised in Art 298 of the CRR regarding close-out netting arrangements which are either contracts for novation, other bilateral agreements or contractual cross-product netting arrangements (Arts 295(a)-(c) of the CRR). Under Art 296(2) of the CRR the default amount must represent the net figure of all positive and negative mark-to-market values of all individual transactions included in the netting set, see Franklin Allen and Elena Carletti, 'Mark-to-market accounting and liquidity pricing' (2008) 45 The Journal of Accounting and Economics p. 358

15 Directive 2006/48/EC

or introduction of reorganisation measures. Another requirement is that financial institutions conduct a risk-sensitive and pragmatic analysis of their credit risk mitigation techniques. Chapter 5 of the Financial Services Authority ("FSA") Handbook introduced this into the English regulatory framework. The relevant provisions in this Handbook were repealed and replaced by the CRR on 1 January 2014. The CRR close-out provision closely resembles the BCD provisions, but contains further clarifications regarding the principles and requirements.

3.1.3.1 Requirements

Various preconditions must be satisfied to benefit from credit risk mitigation techniques.[16] Overall, the objective is to ensure that the obligations will not exceed the net exposure at any times. It shall be noted that credit risk mitigation techniques may be either funded or unfunded. While funded credit risk mitigation requires that some assets, either by the lender itself or by e.g. a third party guaranteeing the transaction, be allocated to cover the risk position, unfunded credit risk mitigation includes contractual mechanisms such as close-out netting. Consequently, funded credit risk protection is primarily concerned with the quality of assets, whereas the make-up of unfunded credit risk protection derives from the (credit) quality of the counterparty and the agreement providing the risk mitigation.

3.1.3.2 Legal opinions

The Basel rules do not contain principles underlying close-out netting. According to Arts 194 and 294 of the CRR, financial institutions are obliged to align their systems and operations underpinned by policies and procedures so as to strengthen the effectiveness of their close-out netting arrangements. The requirements provide amongst others that "the lending institution shall provide, upon request of the competent authority, the most recent version of the independent, written and reasoned legal opinion or opinions that … establish whether its credit protection arrangements meet the condition" that these arrangements are enforceable despite insolvency.[17]

It should be noted that the meaning of sufficient legal review as mentioned in the CRR is undefined, thereby giving financial institutions significant discretion to determine their standards of review. Basel stipulates that financial institutions need to seek legal advice that is recognised in their home jurisdiction. Legal opinions may not be transaction-specific.[18] If an institution engages in the same type of transaction, with entities incorporated under the same laws, it can rely on the same opinion. The opinions must conclude with a high degree of certainty that, in the event of a legal challenge, the relevant courts or administrative authorities will find the exposure to be properly calculated on a

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16 See Arts 205 to 217 of the CRR

17 Art 194(1) of the CRR. This requirement is elaborated by the European Banking Authority, which states that the condition that "credit protection is legally effective and enforceable in all relevant jurisdictions" must be met, which can only be established by "obtain[ing] a legal opinion", see European Banking Authority Single Rulebook Q&A

18 "On the issue of whether an opinion must be specific to the relevant transaction covered and the technique employed by the institution or whether it can be a generic one, it depends mainly on the nature of the two. If an institution engages in the same type of transaction, with counterparties located in the same jurisdiction and uses the same credit risk mitigation technique, then it can rely on the same opinion. For example, if an institution uses a master netting agreement for which a generic opinion exists, it can use that opinion as long as he latter clearly indicates that the agreement is legally effective and enforceable in all the jurisdictions relevant to the transactions covered by that agreement", see Azad Ali and Oliver Abel Smith, *Credit Risk Mitigation and Legal Opinions* (2016) Fieldfisher Publications

net basis. The words "written and reasoned" in the CRR suggest that the legal opinions should not merely state a view, but must be underpinned by legal reasoning.

Legal opinions need to critically determine whether the courts, insolvency practicioner or another authority could undermine or even preclude the validity and enforceability of credit risk mitigation techniques. An adverse analysis will inevitably mean that credit risk mitigation techniques will not be recognised for capital adequacy purposes. Legal opinions, however, include assumptions, representations and qualifications resulting in the carve-out of some unclear issues. Under the resolution regime, financial institutions can become subject to a wide range of interventions. As will be seen, the resolution powers to intervene with contractual rights are extensive and safeguards are untried. Should a financial institution become subject to a resolution measure, the application of that measure will be discretionary. The implications for financial contracts cannot be predicted. Consequently, a qualification as to the effect of resolution measures is inevitable.

3.2 Financial Collateral Directive

The primary objective of the Financial Collateral Directive[19] ("FCD"), or Financial Collateral Arrangements (No 2) Regulations 2003 ("FCARs") as transposed in England, is as follows. It seeks to promote market efficiency by promoting legal certainty concerning the ability to realise financial collateral while protecting creditors.[20]

3.2.1 Effect

The FCARs provide that the financial collateral arrangements shall be enforceable notwithstanding the initiation of insolvency proceedings and restructuring measures.[21] Overall, the FCARs aim to establish the legal framework for creating and enforcing collateral arrangements in order to promote the integration of financial markets and reduce the cost of conducting business. The avenue to promote legal certainty to abolish administrative burdens[22] impeding the validity and enforceability of financial collateral arrangements.[23] Under the various registration and notification rules, which varied extensively between Member States, compliance was difficult - if not impossible. Most

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19 Directive 2002/47/EC. The FCD was transposed as the Financial Collateral Arrangements (No 2) Regulations 2003 ("FCARs"), which came into effect on 26 December 2003.

20 Other objectives of the FCD include integration and cost efficiency of the financial markets (Recital 3), stability of the financial system in the EC (Recital 3), freedom to provide services and the free movement of capital in financial services (Recital 3), rapid and non-formalistic enforcement procedures in order to safeguard financial stability (Recital 17), and limitation of contagion effects in case of a default of a party to a financial collateral arrangement (Recital 17)

21 Look Chan Ho, 'The Financial Collateral Directive's practice in England' (2011) 26(4) Journal of International Banking Law and Regulation p. 151

22 Certain jurisdictions impose formalities regarding the creation of a security, such as notarisation and documentation requirements

23 Miguel Virgos and Francisco Garcimartin, *The European Insolvency Regulation: Law and Practice* (Kluwer, 2004) p. 126

importantly, the fast-paced nature of financial markets rendered protection meaningless.[24] In the words of the Commission:[25]

> Failure to comply with such rules often results in the invalidity of the collateral. This is disproportionate and should be abolished. The suggested Directive would apply only to collateral arrangements which involve delivery of the collateral or in the case of book-entry securities collateral, some form of record of the collateral-taker's interest on the books of the intermediary with which the securities are held. In such circumstances, it is difficult to see that a reasonably diligent third party would be misled as to the true financial situation of the collateral-taker so far as relates to these assets.

The FCARs have dispensed with these formalities and restrictions in relation to financial collateral. Recital (4) of the FCD motivates the need to ensure the enforceability of close-out netting as follows:

> Sound risk management practices commonly used in the financial market should be protected by enabling participants to manage and reduce their credit exposures arising from all kinds of financial transactions on a net basis, where the credit exposure is calculated by combining the estimated current exposures under all outstanding transactions with a counterparty, setting off reciprocal items to produce a single aggregated amount that is compared with the current value of the collateral.

In addition, the FCARs disapply the requirement to register security that is a security financial collateral arrangement[26] as well as other statutory formalities for the creation of security.[27] Any statutory prohibition of the enforcement of security rights, such as moratoria, are also disapplied as are certain insolvency law prohibition and avoidance rules.[28] Accordingly, the FCD provides that a close-out netting arrangement shall take effect in accordance with its terms irrespective of any otherwise mandatory prohibition. Close-out netting under the FCARs and insolvency set-off seem closely related. For instance, the avoidance rules prohibit reliance where there is a notice of the insolvency or impending insolvency of the counterparty. Equal consideration is given to mutual obligations, without preference determining the net balance, which can include future or contingent payments. Yeowart and Parsons argue that this is not coincidental. The close-out provisions were designed on the basis of set-off principles, in particular before Reg 12 of the FCARs came into effect.[29] This was done to ensure that these provisions would be underpinned by the operation of mandatory Rules 14.24 and 14.25 of the Insolvency Rules 2016.

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24 For instance, perfection requirements that must be complied with in order to ensure that the arrangement is enforceable are set out under Ch 25 of the Companies Act 2006. That Chapter stipulates that all security needs to be registered if it does not fall within the limited exceptions set out in section 859A(6) of the Companies Act. This can be considered as an administrative burden given that the security will be adjusted multiple times throughout the lifetime of the agreement. The aim of registration is to make the arrangements public so that the transacting parties can confirm whether they obtained good title to the security or whether it is burdened by another creditor with superior rights to the security. However, for strategic purposes, it is not in the parties' interest to make the structured financial arrangements public. A prudential regulator may also require that a financial institution have "clean" charges registers; failure to comply with this requirement may have significant tax and regulatory capital implications. Given the disparity of requirements across Member States and the requirements of financial markets, abolishing them will strengthen the legal certainty relating to financial collateral arrangements.

25 Recital 14 of Directive 2000/78/EC

26 See section 859A of the Companies Act 2006

27 For example, immovable real property under the Law of Property Act 1925

28 Avoidance of property dispositions after commencement of liquidation proceedings (section 127 of the Insolvency Act 1986); liquidators' right to disclaim onerous property (section 178 of the Insolvency Act 1986); avoidance of certain floating charges (section 245 of the Insolvency Act 1986)

29 Geoffrey Yeowart and Robin Parsons, *Yeowart and Parsons on the Law of Financial Collateral* (Elgar Financial Law and Practice 2016) pp. 224 and 228

In general, the enforcement of security requires the consent of both parties creating the security and if within insolvency, approval by the courts. In contrast, quasi-security arrangements are mostly self-executory or have a mechanism which allows the non-defaulting party to enforce the arrangement. Enforceability of the collateral arrangement is ensured by allowing parties to exercise their contractual rights unfettered by the commencement or continuation of an insolvency proceeding or reorganisation measure.[30] Collateral arrangements can take two forms, namely 'title transfer financial collateral arrangements'[31] or 'security financial collateral arrangements'[32] and encompass cash, financial instruments and credit claims.[33] Any judicial stay or suspension of enforcement or disposition has no implications on the enforceability of the arrangements. Parties cannot rely on this provision if they knew that the counterparty was subject to insolvency proceedings when it concluded a new transaction. Due to the absence of challenges to the enforceability of close-out netting under English law, it may be argued that the effect of the FCD is limited. It nonetheless promotes legal certainty and comfort.

3.2.1.1 Increased liquidity

In *Re Lehman Brothers International (Europe) (in Administration)*,[34] Briggs J acknowledged the merit of financial collateral. The right to substitute means that the collateral taker has the right to replace the assets with another asset or with cash provided it has the same or equal quality and value.[35] This right is essential since the collateral taker is entitled to a pool of assets posted as collateral and not merely a specific asset.[36] The possibility to substitute substantially increases the liquidity of assets. Given that the FCD and FCARs broaden the eligible assets, the collateral taker must have a certain degree of ownership of and control over the collateral.[37] Thus, Briggs J established that the collateral provider must be deemed to have been "dispossessed" of the collateral.[38] The relevant test is that the collateral taker has the exclusive right to dispose the collateral,[39] administrative control is considered insufficient.[40]

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30 Art 7 FCD and Reg 12 FCARs

31 Transferring the full title of the collateral to the collateral taker; see English Transfer Annex

32 Conferring the security right, e.g. a security interest or a charge, on the collateral taker; see Deed and NY Annex

33 Credit claims within the meaning of the Financial Collateral Regulations seems to mean loan receivables

34 *Re Lehman Brothers International (Europe) (in administration)* [2012] EWHC 2997 (Ch) at [134]

35 In *Re Lehman Brothers International (Europe) (in administration)* [2012] EWHC 2997 (Ch) at [134] Briggs J stated that "dispossession" renders the protection of the collateral worthless if the collateral provider's rights are more extensive, see Louise Gullifer, *Goode on Legal Problems of Credit and Security* (5th edn, Sweet & Maxwell 2013), p. 268 and Simon Goldsworthy, 'Taking possession and control to excess: issues with financial collateral arrangements under English law' (2013) Journal of International Banking and Finance Law p. 71. When trading repos, the amount of collateral often equals 103 per cent of the value of the transactions. The reason is that upon default of the short party, the long party can ensure it will be able to keep the securities and can claim the excess collateral as a secured creditor.

36 *Re Lehman Brothers International (Europe) (in administration)* [2012] EWHC 2997 (Ch) at [133]

37 Lindsay Hingston, 'Controls on the scope of the Financial Collateral Directive' (2016) Journal of International Banking and Financial Law p. 525

38 *Re Lehman Brothers International (Europe) (in administration)* [2012] EWHC 2997 (Ch) at [1136]

39 See *Gray v G-T-P Group Limited* [2010] EWHC 1772 (Ch) at [54]

40 Lindsay Hingston, 'Controls on the scope of the Financial Collateral Directive' (2016) Journal of International Banking and Financial Law p. 525, p. 526

3.2.2 Conditions

Since the FCD and FCARs provide significant protection regarding the enforcement of private contracts despite contradicting statutory provisions, the scope of this protection needs to be limited. This limitation draws a balance between the policy promoting economic efficiency and protection of legitimate creditors' interest, thereby promoting market efficiency and financial stability.[41]

The protection afforded by the FCARs is limited to certain legal forms in general, and to legal persons in particular.[42] Initially, the intention was to limit the protection to a constellation where both counterparties were either financial institutions under prudential supervision and certain public institutions such as public authorities and central banks, or other legal persons with a capital base exceeding EUR 100 mn or gross assets exceeding EUR 1 bn.[43] Given that the latter financial threshold seemed somewhat arbitrary, various market participants responded with the concern that this would exclude between 15 to 75 percent of collateral users.[44] Subsequently, the scope was widened such that FCD protection could be invoked if only one counterparty qualified as any of the above, and the threshold amounts were abolished, provided that one of the counterparties is a regulated financial institution.

Only certain collateral arrangements qualify for protection under the FCARs. The term "credit support document" is an umbrella term covering all agreements whereby parties to financial contracts provide collateral by way of title transfer or security interest. The credit support document forms part of the master agreement. The type of the document is decisive for the method of incorporation. The most common ways are either by attaching an annex to the master agreement[45] or by signing a deed which is a standalone document and incorporated by reference.[46] However, securities financing transactions under the GMSLA and GMRA also qualify for protection.

A precondition for the protection is that the set-off or close-out netting arrangement is embedded in the arrangement.[47] As discussed in the previous chapters, this implies that the counterparties' transactions should become immediately due through acceleration or termination, followed by calculation of a single balance. This single balance should represent the market value or replacement cost of all terminated transactions either by applying the obligations against each other or replacing the transaction with a single obligation.

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41 See Recital 10 of the FCD; see also Lindsay Hingston, 'Controls on the scope of the Financial Collateral Directive' (2016) Journal of International Banking and Financial Law p. 525

42 Paras (c) and (d) of the definitions of "title transfer financial collateral arrangement" and "security financial collateral arrangement" of Reg 3 FCARs

43 Art 2(4)(c) of the Proposal for a Directive on financial collateral arrangements, COM(2001) 168 final

44 See International Swaps and Derivatives Association, *ISDA statement of position on Proposal for a Directive on financial collateral arrangements COM(2001) 168 final* and European Financial Markets Lawyers Group, Statement on a proposal for a Directive on financial collateral arrangements, COM(2001) 168 final

45 For instance, the "Credit Support Annex" or "CSA". The main forms are the English-law governed 1995 Credit Support Annex ("English Transfer Annex") and New York law-governed 1994 ISDA Credit Support Annex ("NY Annex")

46 For instance, the "Credit Support Deed" or "CSD". The main form is the English law governed 1995 Credit Support Deed ("Deed")

47 The definition of close-out netting contains a provision on acceleration and on replacement, which suggests set-off and close-out netting respectively, see Reg 3(1) FCARs

The following four critical rules apply. The close-out netting arrangement is contingent upon the occurrence of an "enforcement event",[48] i.e. any event of default whereby the non-defaulting party is entitled to realise collateral and invoke close-out netting.[49] At this point it suffices to say that, due to the aforementioned systemic concerns, enforcement event does not encompass "crisis prevention measures" within the meaning of section 48Z of the Banking Act 2009. Hence, the FCARs do not preclude the application of any Banking Act 2009 measures by the Bank of England ("BoE") with respect to a distressed financial institution.[50]

3.2.3 Criticism

The unrestricted realisation of collateral is not undisputed. In particular, it is argued that the FCARs are, to some extent, *ultra vires* since their effect exceeds the FCD's intention.[51] In this context, it should be pointed out that the enforcement of collateral arrangements can cause liquidity strains on financial institutions - which are already distressed. It has been submitted that public policy justifies this. The enforcement of collateral arrangements despite any imminent or ongoing insolvency proceeding or restructuring measure is socially desirable since it promotes the provision of secured credit, thereby reducing the cost of capital. In the absence of such certainty regarding enforceability, lenders would be more reluctant to provide credit to the economy. As for liquidity strains, it suffices to say that resolution measures can restrict enforcement rights[52] – since they can "cure" the enforcement event. In essence, the ability to re-use or -hypothecate collateral must be understated and appropiately addressed.

Mokal proposed the notion "false wealth"[53], whereby the availability of assets is overstated since these assets have third party claims attached or are otherwise encumbered. Although close-out netting arrangements often comprise financial collateral, the use of collateral is not unique to close-out. Any creation of "froth" is a corollary of the ability to re-use or -hypothecate and of the promotion of money-likeliness of collateral under the FCD. In light of the policy reasons that led to the FCD, it is submitted that limiting the use of close-out netting in order to deflate froth is inappropriate. A more nuanced approach is required.[54]

It may be submitted that encumbrance is undesirable as it reduces the ability of an insolvency administrator or liquidator to seize the debtor's assets, thereby reducing the recovery rate of other

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48 I.e. broadly, an event of default within the meaning of para 11 of the GMRA and GMSLA agreement and s 6 of the ISDA master agreements

49 Reg 3(1A) FCARs

50 Reg 15(5) FCARs

51 See *R (Cukurova Finance International Limited) v HM Treasury* [2008] EWHC 2567 and more recently *United States of America v Nolan* [2015] UKSC 63; see Robert Levy and Daniel Warents, 'Re-opening Pandora's box: *Cukurova,* collateral and constitutionality' (2016) April p. 208

52 In particular 18A of the Banking Act 2009 (restrictions on enforcement of financial collateral arrangements, etc.) disapply regulations 16 and 17 FCARs with regard to right of use under a security financial collateral arrangement and appropriation of financial collateral under a security financial collateral arrangement

53 The term derives from Roman law and coins the risk that misperceived wealth may result in a merchant falsely extending credit to a debtor. See Rizwaan Mokal, 'Liquidity, Systemic Risk, and the Bankruptcy Treatment of Financial Contracts' (2015) 10(1) Brooklyn Journal of Corporate, Financial & Commercial Law p. 9, p. 49 and Steven Schwarcz, 'The Easy Case for the Priority of Secured Claims in Bankruptcy' (1997) 47 Duke Law Journal p. 425

54 Regulation (EU) 2015/2365 (Securities Financing Transactions Regulation) seeks to remediate this problem

creditors. For instance, repos envisage the transfer of assets along with a commitment to repurchase the asset in future.[55] Unsecured creditors cease to have a claim on the asset. It is substituted with the cash leg of the repo. Hence, the claim is merely substituted. Regulatory concerns also apply. First, encumbrance complicates the assessment of the credit risk of unsecured depositors and raises adjacent concerns regarding deposit insurance or schemes such as the Financial Services Compensation Scheme. Second, it perpetuates the liquidity risk of "secured" lenders, since due to encumbrance it may not be possible to realise the collateral and apply it against the obligations. The above concerns do not apply to all transactions. Depending on the transaction type, encumbrance will differ in quantum and quality.

Collateral posted in relation to financial derivatives poses a different risk. Here collateral is used to secure a contingent liability, for which no substantive cash-like value has been received. Thus, unsecured creditors have no alternative for the assets posted, which they could attach or seize if the debtor were to become subject to insolvency proceedings. Thus, whereas the rate of encumbrance is marginal in case of securities financing transactions, since it emanates only from haircuts[56] and contingent encumbrances to cover potential future exposure, in case of collateral related to financial derivatives, it can be more sizable. However, the absence of apparent value for unsecured creditors may not overshadow the productive utilisation of financial derivatives and counterparties' need to mitigate credit risk.

3.3 Settlement Finality Directive

The EU legislator launched the Settlement Finality Directive ("SFD")[57] as part of early financial integration efforts. It was subsequently implemented via Insolvency (Settlement Finality) Regulations 1999/2979 ("Settlement Regulations"). Overall, this Direcive facilitates the functioning of designated multilateral trading systems, also known as FMIs.[58] Besides regulating payment and security settlements, it contains rules relating to insolvency and conflict of laws. A primary objective is to avoid disruptions that may otherwise arise if insolvency proceedings are commenced against a participant.[59] Courts are bound to interpret the Settlement Regulations in such a ways as to achieve this objective.[60] It is said to be the blueprint of the FCD,[61] since it harmonises the process of settling transactions and protects the enforceability of close-out netting arrangements notwithstanding the insolvency of a participant in a designated system. It also ensures the enforceability of any relevant collateral arrangements.

For instance, Reg 14 of the Settlement Regulations stipulates that any default system (i.e. rules of an FMI governing close-out) takes precedence over insolvency in case of inconsistency. In contrast

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55 It is common practice to require that the assets are free of any encumbrances, liens or other attachments

56 These haircuts are also determined by the quality of the asset, for instance illiquid assets are subject to a greater haircut than those that can be easily realised

57 Directive 1998/26/EC

58 Such as, for instance, settlement of payments and security settlement systems

59 Geoffrey Yeowart and Robin Parsons, *Yeowart and Parsons on the Law of Financial* Collateral (Elgar Financial Law and Practice 2016) p. 591

60 Ibid

61 Ibid p. 34

to the FCD, however, it can only be invoked if one party is a critical financial market infrastructure. It hinges on the presumption that in times of crises as well as in normal times, the "ability and confidence to settle obligations when due and to continue transacting" is fundamental to financial markets.[62] Hence, the primary objective is to disapply national rules that can impair the operations of FMIs and to promote measures deemed to facilitate risk management.

3.3.1 Protection of FMIs

If these preconditions are satisfied, the ordinary insolvency proceedings under the Insolvency Act 1986 together with the Insolvency Rules 2016 will not apply. This regime is replaced by another regime with the objective of ensuring the continuity of financial markets notwithstanding the insolvency of their participants. The law governing insolvency is modified by rr 13 to 19 in so far as it applies to transfer orders effected through a designated system and to collateral security provided in connection with participation in the designated system. Reg 20 provides that the modifications to the law of insolvency cease to apply to a transfer order which is entered into a designated system after insolvency unless the transfer order is carried out on the same day as the insolvency occurs and the relevant persons did not have notice of the insolvency at the time of settlement. Regulations 13 to 19 also apply to collateral security which is provided to a central bank in connection with its functions as a central bank.

Where a court makes an insolvency order against a participant in a designated system, the court is required by virtue of Reg 22 to notify both the relevant designated system and the relevant designating authority that such an order has been made. Similarly, para 5(4) of the Schedule provides that a designated system must require a participant to notify the system and the relevant designating authority that a resolution has been passed for a creditors' voluntary winding up of the participant or that a trust deed granted by the participant has become a protected trust deed.

3.3.1.1 Close-out netting

Set-off and close-out netting arrangements underpin the seamless operation of FMIs.[63] Agreements containing netting arrangements connected to the participation are governed by the governing law elected by the parties.

3.3.1.2 Collateral

Any other rights or obligations arising from or in connection with participation in a system designated under the FCD are to be determined by the law governing the system.[64] Under Reg 23 of the Settlement Regulations, the law of the location (*lex situs*) where the securities are recorded, e.g. in a register, account or centralised deposit system, shall be the governing law determining the

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62 Lawrence Sweet, 'CPSS-IOSCO Principles for financial market infrastructures: Introduction and highlights' (2012) Workshop on Principles for Financial Market Infrastructures, South African Reserve Bank p. 3, p. 20. ISDA reaffirmed that FMIs must be unaffected by any measure applied to participants, see International Swaps and Derivatives Association, *CCP Loss Allocation at the End of the Waterfall* (2013) p. 20

63 Chryssa Papthanassiou, 'Financial market infrastructures in stress scenarios' in Jens-Hinrich Binder and Davinder Singh (eds) Bank Resolution: The European Regime (Oxford University Press 2016) p. 327

64 R 24 Settlement Regulations

enforcement. In case the securities are held by an intermediary, the Place of the Relevant Intermediary Approach ("PRIMA") rule applies.[65]

3.3.2 Criticism

The framework has been proven to be robust in practice, as can be derived from the absence of any challenge in the courts of England or elsewhere. It may be suggested that the precedence given to the default rules that govern FMIs over national insolvency laws is unfair with respect to creditors that do not participate in this system. However, due to the requirements that participants in FMIs need to fulfil, which narrows the protection, and the ascribed importance of FMIs for systemic stability, this preference is widely accepted as appropriate.

3.4 The Reorganisation and Winding-up of Credit Institutions Directive

The harmonisation of insolvency law across Europe has been a desirable, yet unachievable legislative undertaking. The primacy of the member states' own legislative regime in this very distinctive legal area is considered to be a prohibitive obstacle.[66] For instance to prevent inefficiencies arising from the disparate insolvency regimes, such as the commencement of multiple proceedings, the European legislator introduced conflict-of-laws measures relating to financial institutions. The Reorganisation and Winding up of Credit Institutions Directive ("RWuD")[67] as transposed by the Credit Institutions (Reorganisation and Winding Up) Regulations 2004[68] ("2004 Regulations") represents the first attempt towards a more harmonised regime. Its primary objective is to establish an EU conflict-of-laws framework for insolvency proceedings and restructuring measures applicable to financial institutions.[69] It establishes a framework for the cross-border recognition of insolvency proceedings and administration measures. In particular, such recognition must not require any further formalities between the relevant insolvency courts or authorities.[70] The following will discuss the emergence and effect of the Reorganisation and Winding up of Credit Institutions Directive.

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65 This rule means that the book-entry securities are deemed to be situated at the place of the registered office of the intermediary keeping the relevant securities account. As a general rule, it is the place specified in the securities custody agreement between the account holder and the intermediary (custodian). See Jeroen Van Der Weide and Bob Wessels, 'Where to locate assets, subject to certain security rights?' (2011) 26(8) Journal of International Banking Law and Regulation p. 369 and Maisie Ooi, 'Case Comment: Intermediation and its effect on investor rights' (2015) 131(Oct) The Law Quarterly Review p. 536

66 See Diego Valiante, *Harmonising insolvency laws in the Euro area: Rationale, stock-taking and challenges. What role for the Eurogroup?* (July 2016) European Parliament, Economic and Monetary Affairs Committee, Philipp Paech, 'Close-out Netting, Insolvency Law and Conflict-of-Laws' (2014) LSE Law, Society and Economy Working Papers 14/2014, Philipp Paech, 'Market Needs as Paradigm – Breaking up the Thinking on EU Securities Law' in Henri Conac, Ulrich Segna, Luc Thévenoz (eds) *Intermediated Securities* (Cambridge University Press 2013), 22-64

67 Directive 2001/24/EC

68 SI 2004/1045

69 Gabriel Moss, 'Commentary on Directive 2001/24/EC on the Reorganisation and Winding-Up of Credit Institutions' in Gabriel Moss QC, Bob Wessels and Matthias Haentjens (eds) *EU Banking and Insurance Insolvency* (2nd edn, Oxford University Press 2017)

70 See Migues Virgós and Francisco Garcimartín, 'Conditional conflict of laws rules: A proposal in the area of bank resolution and netting in cross-border scenarios' (2012) 9(2) International Corporate Rescue p. 91

3.4.1 Background

Due to Member States' insistence on the superiority of their insolvency laws, substantive insolvency law harmonisation has been troublesome.[71] Even after the financial crisis of 2007 there seemed to be insufficient support justifying the harmonisation of insolvency laws. Under the 2004 Regulations, the coordination of home and host authorities' efforts has been facilitated. In broad terms, the 2004 Regulations aim to grant judiciary and administrative authorities powers to initiate insolvency proceedings or reorganisation measures against a domestic financial institution and its affiliates in Europe. Such proceedings also include powers to suspend certain obligations[72] and termination rights.[73]

Moreover, the RWuD recognises national legal orders, including the preferential treatment of creditors. An objective concerning the distribution of realised assets is the coordination of proceedings through uniform rules on conflict of laws. This is thought to preserve equal treatment of creditors. Without a unified approach, differences among Member States can lead to obstructions in the distribution process and, possibly, to litigation.

3.4.2 Effect

The effect of the 2004 Regulations is the harmonisation of private international law rules relevant to 'winding-up proceedings'[74] and 'reorganisation measures'.[75] Two principles guide this harmonisation. First, the home authorities of the parent reserve the right to instigate insolvency proceedings. The risk that competing proceedings are instigated against subsidiaries and branches in other Member States is thereby reduced.[76] Second, given the extended jurisdiction of the home authorities, the laws and proceedings of the home member states shall be applied but with a few exceptions. Chief exception for the current purpose is the election of the governing law of certain financial contracts elected by the parties, as will be discussed below.[77] Unsurprisingly, this approach is described as

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71 Philipp Paech, 'Close-out Netting, Insolvency Law and Conflict-of-Laws' (2014) 14(2) Journal of Corporate Law Studies p. 419 and Eva Hüpkes, 'Insolvency – why a special regime for banks?' (2005) Current Developments in Monetary and Financial Law, p. 471; Federico Mucciarelli, 'Not just efficiency: insolvency law in the EU and its political dimension' (2013) 14 European Business Organization Law Review p. 196; Giorgio Cherubini, Neil Cooper, Daniel Fritz, Emmanuelle Inacio, Katarzyna Ingielewicz, Guy Lofalk, Miriam Mailly, David Marks QC, Anna Maria Pukszto, Barbara F.H. Rumora Scheltema, Robert Van Galen, Miguel Virgos, Bob Wessels, Nora Wouter, 'Harmonisation of insolvency law at EU level' (2010) A report prepared for the European Parliament's Committee on Legal Affairs PE 419.633, p. 27

72 Art 69 of the BRRD, see 5.2.3.1 below

73 Art 71 of the BRRD, see 5.2.3.1 below

74 Defined in Art 2 of the RWuD as 'collective proceedings opened and monitored by the administrative or judicial authorities of a Member State with the aim of realising assets under the supervision of those authorities, including where the proceedings are terminated by a composition or other, similar measure'

75 Defined in Art 2 of the RWuD as 'measures which are intended to preserve or restore the financial situation of a credit institution and which could affect third parties' pre-existing rights, including measures involving the possibility of a suspension of payments, suspension of enforcement measures or reduction of claims', which has been amended to accommodate resolution tools and measures pursuant to Article 117 BRRD. It suggests that resolution is also partly considered to belong to the realm of insolvency. See Rebecca Stubbs, 'Tchenguiz v Kaupthing: claims against credit institutions on a reorganisation and winding-up' (2011) 26(7) Journal of International Banking and Financial Law p. 392 and George Walton, 'Rawlinson and Hunter Trustees SA v Kaupthing Bank HF [2011] EWHC 566 (Comm)' (2011) 4(3) Corporate Rescue and Insolvency p. 103

76 Arts 3(1) and 9(1) of the RwuD

77 Art 25 of the RWuD

unitary proceedings. Due to various exceptions and qualifications, its overall operability and effect are undermined.[78]

3.4.3 Criticism

According to Reg 28 of the 2004 Reg , set-off shall remain enforceable despite the initiation of reorganisation or liquidation proceedings, provided that set-off is permitted by the relevant laws of the *situ* of the financial institution.[79] However, pursuant to Reg 34 of the 2004 Regulations "[n]etting [a]greements shall be governed *solely* by the law of the contract which governs such agreements".[80] Somewhat ambiguously, regulation 34 suggests that the contractually determined governing law will concurrently govern any substantive law and proceedings. It suggests an implicit override of insolvency proceedings notwithstanding any conflicting provision.[81] Alternatively, it could mean that the insolvency proceedings of the jurisdiction of the financial institution will apply and that only the mechanisms, jurisdiction and interpretation relating to its terms will be subject to the elected governing law.[82]

From a practitioner's perspective, the former is preferable, in light of the fact that the "implant" does not cause any potential misconstruction due to language and implied meaning, promotes certainty and does not require examination of the insolvency laws of all jurisdictions where the financial institution is active.[83] Another flaw of Reg 34 of the 2004 Regulations is its failure to define or specify envisaged "netting agreements". In the above discussion on set-off we have seen that set-off produces a similar economic outcome as close-out netting. Accordingly, contractual set-off arrangements, which in effect may even be close-out netting agreements, are presumably covered. Due to this ambiguity it is unclear whether Regs 28 or 34 of the 2004 Regulations shall apply.[84]

Ole Böger discussed the issue in the context of English courts in respect of *Re Bank of Credit and Commerce International SA (No. 10).*[85] It held that the proceedings of the *situ* were applicable irrespective of the elected governing law. In other words, the statutory insolvency set-off provisions are deemed "internationally mandatory".[86] Consequently, the protection accorded to close-out

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78 See Adrian Cohen and Roger Best, 'European court gives guidance on the winding up directive for banks' (2015) 1 Corporate Rescue and Insolvency p. 28

79 Rule 28 of the 2004 Regulations

80 Emphasis added

81 This position is unclear and there have been no cases relating to Regulation 34 or the articles of the FCD, in either England or Europe

82 This is not a transposition error. The relevant RWuD Arts are 24 and 25.

83 See Rajesh Pillai and Hannah Glover, 'Case comment: ISDA Master Agreement: party choice versus non-derogable state law' (2016) 31(7) Butterworths Journal of International Banking & Financial Law p. 401 and Shearman & Sterling, 'Case Comment: United Kingdom: jurisdiction clauses - English law choice of law clauses' (2016) 31(8) Journal of International Banking Law and Regulation p. N 108

84 To add another layer of confusion, Regulation 35 of the 2004 Regulations (or Art 26 of the RWuD) provides that the winding-up and reorganisation proceedings under the law elected as governing law shall be applied in case of repos

85 Ole Böger, 'Close-out netting provisions in private international law and international insolvency law (Part II)' (2013) 18(4) Uniform Law Review p. 532, pp. 537 to 38 and *Re Bank of Credit and Commerce International SA (No 10)* [1997] Ch 213 (ChD)

86 Cf See Lawrence Collins et al, Dicey, Morris and Collins on the Conflict of Laws (14th edn, Sweet & Maxwell 2006) volume 2, p. 1438, para 30-188 and p. 1393, para 30-113; Philip Smart, Cross-Border Insolvency (2nd edn, Bloomsbury 1998) p. 320; Ian Fletcher, 'International Insolvency Issues: Recent Cases' (1997) Journal of Business Law p. 471, p. 483; see also Pippa Rogerson, 'International Insolvency: Law Applied to Distribution' (2008) 67 Cambridge Law Journal p. 476, p. 477

netting agreements is overridden by the English insolvency set-off rules, irrespective of whether the court otherwise defers to foreign insolvency law.[87] However, another Member State may decide differently.

In *Re HIH Casualty and General Insurance Ltd*[88] Lord Hoffman criticised the above decision. He opined that a sufficiently close connection test should be applied.[89] Pursuant to this test, the court examines whether there is a legitimate interest in the elected governing law, i.e. whether the governing law is the law of the *situ* of one of the counterparties or whether it is otherwise relevant. Lord Scott disagreed, however, in that Lord Hoffman's interpretation could result in domestic creditors' rights being deprived of domestic insolvency set-off rights.[90] Given the absence of certainty of Lord Hoffman's test, the majority of the House of Lords embraced Lord Scott's suggestion.[91]

The above discussion does however not suggest that parties' choices of governing law will be set aside *ab initio*. In accordance with the RWuD, parties are permitted to enforce their rights under the close-out arrangements as underpinned by the elected governing law. Should they fail to enforce their rights and a liquidator or administrator instigates set-off under the insolvency law, local law and not the governing law of the contract will govern the rules of this set-off. It should be recalled that the purpose of the RWuD, and by implication of the 2004 Regulations, is not the substantive harmonisation of insolvency proceedings, but their coordination. As a consequence, the determination of the governing law depends on the actual implementation of the RWuD in the other Member States where the financial institution is active.[92] Similarly, given the disparity of measures and proceedings across European jurisdictions, it may be submitted that the coordination and execution of strategies has been unsuccessful. Another shortcoming of the RWuD is that it does not reduce national competent authorities' tendency to ring-fence. Lastly, despite the inherent complexity of financial institutions, the absence of preparation inevitably results in pressure once proceedings have to be instigated, thereby making rescue (with recourse to public funds) the favoured alternative.

3.5 Conclusion

The above expedition into European law in order to assess the recognition and merits of close-out netting allows drawing the following conclusions. First, for a considerable amount of time regulators have recognised the risk-reducing effects of close-out netting and collateral. This recognition has been enshrined and specified in the CRR. Thus, financial institutions can reflect these effects by allocating less capital to absorb potential losses – provided the close-out netting arrangement meets essential preconditions, such as that independent legal advice asserts that the net obligation

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87 However, see *Tchenguiz and other v Kaupthing Bank* [2017] EWCA Civ 83 discussed by Hoskins and O'Leary, and Henry Hoskins and Sam O'Leary, 'Conflict between two different governing laws and jurisdictional rules' (2017) Journal of International Banking and Financial Law p. 313

88 *Re HIH Casualty and General Insurance Ltd* [2008] 1 WLR 852

89 Ibid 858

90 Ibid 870

91 Rory Derham, *Set-Off* (4th edn, Oxford University Press 2010) para 6–117

92 Clare Reffin, 'The UK regulations implementing the Credit Institution Directive: an unintended loophole' (2009) 24(9) Journal of International Banking and Financial Law p. 534. See also *Jefferies International Limited v Landsbanki Islands HF* [2009] EWHC 894 (Comm)

calculated in accordance with the master agreements is valid, binding and enforceable – despite ongoing or pending insolvency proceedings or restructuring measures.

Within Europe, the enforceability of credit risk mitigation techniques is ensured by the FCD, which overrides any national law provisions that would ban, restrain, prohibit or delay enforcement of collateral and embedded close-out netting arrangments. Even in cases where the FCD does not apply, because the debtor is not a financial institution or the netting provisions are not part of a collateral arrangement, or the Settlement Finality Directive does not apply, the RWuD ensures the enforceability of close-out netting provisions in respect of failing financial institutions. In England, close-out netting arrangements are enforceable as a general principle of law despite insolvency. With this in mind, it can be argued that these contracts do not have special status resulting from a safe harbour but are permissible as they do not offend or thwart the operation of other laws. Not only financial institutions benefit from credit risk mitigation techniques. Their application is much broader and extends to other entities which are deemed critical for financial stability. Thus, this chapter considered EU legislation relating to financial market infrastructures. The discussion has elucidated that close-out netting forms an integral part of the protection of such infrastructures.

Overall, close-out netting plays a crucial role in EU prudential and capital markets law. It promotes the international competitiveness of EU financial institutions. Also within Europe, legislation supporting close-out netting has been essential for the integration of financial markets and the promotion of sustainable economic development. It is germane to reiterate that this framework supports contracts which are vital for risk management while releasing valuable assets that would otherwise be encumbered.

Chapter 4
The financial crisis of 2007

When assessing a new legislative framework, it is germane to reflect on the events that shaped the current reform and the introduction of new legislation as well as any resulting anticipated developments. The objective of this chapter is to set out fundamental concepts, notions and developments in the context of the overall objective of this thesis. In particular, it will show the inaptness of insolvency measures amd principles to manage financial institutions posing systemic risk. It argues that resolution regimes, in contrast to insolvency regimes, primarily aim to separate operating from financial liabilities. It should be noted the BRRD has, in principle, achieved such separation, but, in turn, blurs it by allowing the execution of resolution measures against operating claims. Against this background, it may be concluded that the regime for managing distressed financial institutions needs to be addressed accordingly.[1] An inherent feature of financial institutions is that distress can undermine financial stability.[2] This insight culminated in a global legislative initiative establishing crisis management regimes pertinent to financial institutions. The discussion in this chapter is structured as follows.

The argument regarding systemic risk should be strictly limited to financial institutions and its counterparties since financial interconnection is required for the transmission of distress. The pricing of derivatives is complex and volatile. As a consequence, the exposure between parties is continuously changing such that, due to market movements, a net obligation may reverse into a net claim. Such volatile exposure necessitates a mechanism facilitating its management and requires "[t]he use of flexible and liquid collateral".[3] On the other hand, it has been suggested that the ability to close out has replaced financial instruments with a more extended tenor that are considered safer.[4]

However, systemic risk does not emanate from the presence of close-out netting. The adverse effects commonly ascribed to netting have other causes. Examples of such causes are the number of standardised arrangements facilitating herding behaviour, the pivotal role of financial contracts for financial institutions, and, to some extent, complexity. Moreover, systemic risk arises from the complex and inextricably linked operations of financial institutions. Constraining the ability to net would therefore negate the benefits while failing to address the more obvious issues.

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1 See for background Eva Hüpkes, 'Insolvency – why a special regime for banks?' (2003) 3 IMF Current Developments in Monetary and Financial Law 13

2 This assertion was certainly true during the financial crisis and in its direct aftermath. More recently, however, attention has diverted to financial market infrastructures such as CCPs. See Financial Stability Board, *Guidance on Central Counterparty Resolution and Resolution Planning. Consultative Document* (2017)

3 Louise Gullifer, 'What should we do about financial collateral' (2012) 65 Current Legal Problems p. 377, p. 382

4 Viral Acharya and Sabri Öncü, 'A proposal for the resolution of systemically important assets and liabilities: The case of the repo market' (2013) 9 International Central Banking p. 291, p. 307

The first section explores the merits and deficiencies of the regime that prevailed at the time of the default of Northern Rock Plc. During the financial crisis of 2007, it transpired that insolvency regimes in the most advanced jurisdictions were not robust enough to dissolve or restructure financial institutions. In its response to the financial crisis, the English legislator, together with the predecessor of the Financial Conduct Authority,[5] HM Treasury and the Bank of England ("BoE") acted exemplary in many ways.[6] However, their means to intervene were limited. As a result of the inaction or absence of relevant measures and procedures, ramifications transcended beyond the insolvent institutions to other financial institutions. Therefore, global consensus was reached as to the need for a new crisis management framework.[7] The BoE spearheaded this process and was most active in reforming the insolvency framework to accommodate financial institutions.

The second section discusses the insights gained from the most significant financial institution failure in 2008, namely Lehman Brothers. Its demise precipitated the existing distress and presumably led to a sharp decline in interbank lending thus evidencing uncertainty regarding the counterparties' ability to continue as going concern. There were other revelations. The financial crisis illustrated that financial institutions are different from other commercial entities.[8] This difference surfaced most noticeably as follows: The experience of the 2007 financial crisis has shown that failing financial institutions are unlikely to be able to continue operating effectively. Consequently, they are more likely to be subject to a system of liquidation than to one of administration.[9]

The third section analyses the effects of the insights of the 2007 financial crisis on the regulatory concepts. These effects were not limited to mere adaptation of the existing regime to market developments. This section argues that the regulatory concepts underwent a paradigm change. Without such change, it would not have been possible to devise and establish a regime capable of containing distress of large and complex financial institutions.

The fourth section reflects on the international standards that informed and shaped the current recovery and resolution regime applicable to financial institutions. While drawing on the insights from the financial crisis discussed in section 3, it deliberates on the minimum requirements for managing large and complex financial institutions. In line with the theme of this thesis, the developments pinpoint the importance of credit risk mitigation techniques. However, the complications posed by the recovery and rehabilitation of a distressed entity are also considered. Thus, in the context of resolution, the introduction of temporary stays is proposed – which is discussed in the next chapter.

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5 The Financial Services Authority was replaced by the FCA

6 Martin Hellwig, 'The problem of bank resolution remains unsolved: A critique of the German ban restructuring law' in Patrick Kenadjian (ed) *Too Big To Fail – Brauchen wir ein Sonderinsolvenzrecht für Banken?* (De Gruyter 2012) p. 36

7 Martin Čihák and Erlend Nier, 'The Need for Special Resolution Regimes for Financial Institutions—The Case of the European Union' (2009) IMF Working Paper WP /09/200 and the Financial Stability Board, Key Attributes of Effective Resolution Regimes for Financial Institutions (2011 as amended in 2014)

8 See Franklin Allen, Elena Carletti and Xian Gu, 'The roles of banks in financial systems' in Allen Berger, Philip Molyneux and John Wilson (eds) *The Oxford Handbook of Banking* (2nd, Oxford University Press) p. 27 and Richard Herrring and Jacapa Carmassi, 'Complexity and systemic risk: What has changed since the crisis?' systems' in Allen Berger, Philip Molyneux and John Wilson (eds) *The Oxford Handbook of Banking* (2nd, Oxford University Press) p. 77

9 See Bank of England, HM Treasury the Financial Services Authority, *Financial stability and depositor protection: further consultation* (Cm 7436, 2018) p. 137

The last section concludes. It recapitulates that the negative effects of the 2007 financial crisis cannot be ascribed to close-out netting. In fact, the foregoing discussions have shown that deficiencies in regulatory notions promoted standardisation, and, as a consequence, distress can be propagated thus exacerbating distress. It is argued that it has become evident that regulators must intervene and preempt culmination of distress, or must be better equipped to manage and contain it – without resorting to extraordinary and public funds. This argument is further developed in the next chapter.

4.1 The challenges of crisis management

The insolvency of Northern Rock plc was the first sign of the looming financial crisis.[10] This credit institution sought financial assistance from the BoE in September 2007. The inability to continue without external, extraordinary assistance was anticipated by Northern Rock's counterparties. In light of the severe distress, they refused to roll over existing securities financing transactions.[11] Consequently, Northern Rock plc suffered a viability-threatening liquidity shortage. The BoE therefore provided emergency assistance in the form of lender of last resort.[12] Once the news of the BoE's support transpired, depositors sought to withdraw their deposits on pain of loss resulting from potential failure.[13] It was the first run on a bank in 140 years.[14] After considering the depth of the distress, the BoE ordered Northern Rock's nationalisation in February 2008.[15] This nationalisation was effected under emergency legislation in the form of the Banking (Special Provisions) Act 2008 ("2008 Act"). When presenting the bill to the House of Commons, Alistair Darling expressly restricted its application to Northern Rock Plc.[16] However, in view of the looming failure of other financial institutions, it was considered wise to introduce a sunset clause to limit the application of these extraordinary measures effect that its application would not be confined to a particular institution.[17] The pre-amble stipulated its purpose as follows:

> An Act to make provision to enable the Treasury in certain circumstances to make an order relating to the transfer of securities issued by, or of property, rights or

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10 Due to the severity of the global ramifications following its default, Lehman Brothers has received more attention; see Hyun Song Shin, 'Reflections on Northern Rock: The bank run that heralded the global financial crisis' (2009) 23 Journal of Economic Perspectives p. 101

11 House of Commons Treasury Committee, *The run on the Rock: Fifth Report of Session 2007–08* (Vol I, 2008), together with formal minutes, para. 57 and Roman Tomasic, 'The rescue of Northern Rock: nationalisation in the shadow of insolvency' (2008) Corporate Rescue and Insolvency p. 109

12 Paula Moffatt and Andrew Campbell, ' UK depositor protection in the aftermath of the banking crisis' (2010) Journal of International Banking Law and Regulation p. 486 and John Armour, Dan Awrey, Paul Davies, Luca Enriques, Jeffrey Gordon, Colin Mayer and Jennifer Payne, *Principles of Financial Regulation* (1st edn, Oxford University Press 2016) pp. 324 sq

13 John Armour, Dan Awrey, Paul Davies, Luca Enriques, Jeffrey Gordon, Colin Mayer and Jennifer Payne, *Principles of Financial Regulation* (1st edn, Oxford University Press 2016) pp. 320 sq

14 A similar event occurred during the collapse of Overend, Gurney & Co in 1866

15 In recent history (temporary) nationalisation was also employed to deal with failing banks, e.g. Bank of Credit and Commerce International SA in 1991 and Barings plc in 1995; in the case of Northern Rock, Chancellor of the Exchequer Alistair Darling stated, in the legislative impact statement accompanying the special framework established to rescue Northern Rock, that the 'Government intends to return the bank to the private sector when market conditions make that possible'

16 Para 36 of the Chancellor's Statement on Northern Rock of 18 February 2008 available at http://webarchive.nationalarchives.gov.uk/20100407200332/http://www.hm-treasury.gov.uk/statement_chx_180208.htm <accessed on 18 October 2017>

17 See section 4.1.1; the Act contained a "sunset clause" envisaging repeal after 12 months. However, this was extended by giving the Treasury the right to repeal the Banking (Special Provisions) Act 2008 by way of order pursuant to section 262 of the Banking Act 2009. This 2009 Act envisaged that its substantive provisions shall come concurrently into effect

> liabilities belonging to, an authorised deposit-taker; to make further provision in relation to building societies; and for connected purposes.

Mervyn King[18] observed that rescue by nationalisation was necessary and that there was no feasible alternative. It was a measure of 'last resort'.[19] Given the costly nature of such nationalisation, the regime was temporary and was meant to remediate pending problems. However, it was not supposed to become a permanent solution for managing distressed financial institutions.[20] According to King, the BoE was unable to actively intervene and resolve the distress due to lack of powers.

Nonetheless, the 2008 Act was invoked multiple times in relation to other financial institutions.[21] Under the 2008 Act, the Treasury was empowered to issue transfer orders, which had the effect of varying terms of debt instruments and extinguishing share options. Surprisingly, these measures have been praised for constituting legal innovations under the BRRD, as will be seen below. The measures were supplemented by a suspension restricting the rights of trade creditors, including counterparties to financial contracts. In particular, it stipulated that transferred contracts could not be terminated early. The preferred measure was orders effecting the transfer to private institutions since this did not burden public finances to the same extent as public ownership. However, these limited funding opportunities represented a significant obstacle, requiring a more comprehensive regime.

The demands for a more comprehensive regime were echoed globally and had been circulating at least since early 2008.[22] The prevailing understanding was that the financial crisis was an 'insolvency crisis'.[23] It comes as no surprise that English insolvency reform occupied the most prominent place in the reform discussions. In particular, the discussions revealed a complete lack of confidence in insolvency laws:[24]

> Current insolvency procedures do not offer an appropriate platform for dealing with a failed bank for a variety of reasons, not least the fact that depositors are likely to be deprived of access to their accounts, and that insolvency is incompatible with the [Bank of England, HM Treasury the Financial Services Authority's] objectives around securing faster depositor payout.

Therefore, it is necessary to conceptualise ordinary insolvency laws and explore the need for and merits of an insolvency law relating to financial institutions.

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18 Former Governor of the Bank of England

19 See Rodrigo Olivares-Caminal, John Douglas, Randall Guynn, Alan Kornberg, Sarah Paterson, Dalvinder Singh, Hilary Stonefrost, *Debt Restructuring* (Oxford University Press 2011) p. 260

20 The Treasury Committee of the House of Commons severely criticised the handling of the rescue of Northern Rock in*The Run on the Rock* report (HC 56-1, 2008) and the FSA's report on the regulatory response of April 2008, see The Financial Services Authority's internal audit review of its supervision of Northern Rock, and the FSA management response available at http://www.fsa.uk/pages/Library?other_publications/miscellaneous/2008/nr.shtml

21 The financial institutions were Northern Rock, Bradford & Bingley, Kaupthing Singer & Friedlander Limited, and Heritable Bank

22 Bank of England, HM Treasury and the Financial Services Authority, *Financial stability and depositor protections: strengthening the framework* (Cm 7308, 2008) and Bank of England, HM Treasury and the Financial Services Authority, *Financial stability and depositor protection: further consultation* (Cm 7436, 2008)

23 Citing former US Federal Reserve Chairman Alan Greenspan, Financial Times, 4 August 2008

24 Bank of England, HM Treasury and the Financial Services Authority, *Financial stability and depositor protection: further consultation* (Cm 7436, 2018) para 1.42

4.1.1 Ordinary insolvency law

Insolvency laws form an integral part of the economy. Together they frame the ability to transact and invest and to militate against uncertainty about inefficiencies and creditor treatment.[25] Moreover, insolvency laws envisage a regime for rehabilitating a distressed entity with the purpose of allowing it to continue as going concern.[26] Averting liquidation is considered a primary objective, but only if the distressed institution is irreversibly insolvent. A general objection against liquidation follows from the concern that the proceedings may destroy value and therefore a rehabilitation is desirable from a economical and social perspective. Although insolvency law performs such a fundamental function, it is somewhat surprising that it has no statutory definition.[27] It is evident, however, that it serves the overall objective of collectively satisfying proven creditor claims under the auspices of an administrative authority and involves the consequent dissolution of the debtor.[28]

It is noteworthy that traditional insolvency law has been developed with companies and not financial institutions in mind. Today's financial markets also have additional requirements which require an adaptation insolvency laws and its principles. Insolvency laws should not be entirely disregarded in context of financial institutions, provided that compensation of depositors and continuity of banking services are ensured. For instance, the transfer order in relation to Kaupthing contained overriding objectives.[29] The provisions of the transfer order realigned the objectives of administration with financial stability by overriding para 3(1) of Schedule B1 to the Insolvency Act 1986. It was stipulated that services and facilities required by the transferee, i.e. Internationale Nederlanden Groep, also known as ING, had to be continued.

Disproportionate use of resolution erodes the rights of creditors in the event of insolvency of a bank given the broad resolution authorities' discretion and powers. As a consequence, confidence in the banking system may be lost and a competitive disadvantage may be created for financial institutions in the relevant jurisdiction. In principle, ordinary or modified insolvency proceedings are to be preferred to the extent that no systemic ramifications are expected, since the courts have a greater expertise relating to insolveny matters and there is numerous precedences which promotes certainty. English law provides for a variety of insolvency proceedings that can be applied against financial institutions. These different regimes consider the degree of distress and whether the distressed financial institution is licensed to accept regulated deposits insured by the Financial

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25 See Diego Valiante, Harmonising insolvency laws in the Euro Area: Rationale, stock-tacking and challenges. What role for the Eurogroup? (2016) European Parliament, Economic and Monetary Affairs Committee and Hamish Anderson, 'What is the purpose of insolvency proceedings?' (2016) 8 Journal of Business Law p. 670

26 See Schedule 16 to the Enterprise Act 2002

27 See Gerard McCormack, 'Equitable influences and insolvency law' (2014) 7(3) Corporate Rescue and Insolvency p. 103. He cites the definition in Regulation 1346/2000 on Insolvency Proceedings. "Insolvency proceeding" within the meaning of the Regulation means, as specified in Art 2(a), the collective proceeding that entails the "partial or total divestment of a debtor and the appoint of a liquidator"

28 See Lord Hoffmann in Cambridge Gas Transport Corporation v Official Committee of Unsecured Creditors of Navigator Holdings Plc [2006] UKPC 26; [2007] 1 AC 508 paras 14-15

29 Rodrigo Olivares-Caminal, John Douglas, Randall Guynn, Alan Kornberg, Sarah Paterson, Dalvinder Singh, Hilary Stonefrost, *Debt Restructuring* (Oxford University Press 2011) p. 262

Services Compensation Scheme ("FSCS") or to deal in investments as principal or as agent, or to manage investments, under section 4(A) of the Financial Markets and Services Act 2000.

The Banking Act 2009, which partly transposes some of the BRRD sections on resolution, provides for insolvency and administration proceedings relating to banks, investment banks, investment firms and building societies. The regime to be applied will depend on legal constitution and licences, presence of depositors and degree of distress. Although the UK has various proceedings, those contained in the Insolvency Act 1986 and Insolvency Rules 2016[30] in conjunction with the Financial Markets and Services Act 2000 remain the main procedures for those institutions that do not qualify for resolution under the Banking Act 2009.

The following insolvency proceedings are conceivable in this respect: liquidation (including provisional liquidation); administration; bank insolvency; bank administration; investment bank special administration; special administration (bank insolvency); special administration (bank administration); administrative receivership; receivership; voluntary arrangements; schemes of arrangement; and for banks that can be qualified as small companies within the meaning of section 382 of the Companies Act 2006, moratorium; see Table 1: Insolvency proceedings applicable to financial institutions on page 155. The procedures are broadly based on the general administration procedure regarding companies under Schedule B1 to the Insolvency Act 1986. Any modifications to the general regime owing to the legal and structural differences of financial institutions are further broken down as to whether they predominately operate a trading book or banking book.

It has been established above that the general insolvency regime is inappropiate to stabilise (parts of) financial institutions or limit systemic ramifications. A trading book includes, for instance, prime brokerage services for clients and proprietary trading, whereas a banking book provides for the more traditional taking of (regulated) deposits and provision of loans and mortgages. The trading book is more complicated since assets need to be re-evaluated daily (also referred to as marked-to-market) and are held across jurisdictions by various group entities or third parties such as custodians, sub-custodians, CCPs and clearing houses[31]. This constellation complicates the reconciliation of claims that should be allocated to creditors, and of client assets and monies of the insolvent institution. In contrast, the assets of the banking book are valued less frequently and depend predominantly not on operational and market risk but on inadequately provisioned or sudden losses due to credit risk. The following subsection discusses legal form-specific considerations.

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30 It is also conceivable to initiate a scheme of arrangement under the Companies Act 2006, but this applies only to very small banks and is unlikely to work in practice. Therefore, the following discussion will concentrate, in case of credit institutions, on the bank insolvency procedure under Part 2 of the Banking Act 2009, and the bank administration procedure under Part 3 of the Banking Act 2009; in case of investment banks, on the special administration (bank insolvency) under the Investment Bank Special Administration Regulations 2011 (SI 2011/245) and the special administration (bank administration) under the Investment Bank Special Administration Regulations 2011. There are also further proceedings if the bank does not accept eligible deposits within the meaning of section 93(3) of the Banking Act 2009, i.e. those deposits qualifying for deposit insurance under the Financial Services Compensation Scheme

31 The main difference between a CCP and a clearing house is that the former interposes itself between two parties. Thereby, it becomes a buyer for the seller and a seller to the buyer. Clearing houses however, do not take a proprietary position, but merely match the transactions to facilitate settlement

4.1.2 Traditional proceedings applied to financial institutions

Before the financial crisis, there had only been a few cases of bank insolvencies in England.[32] These were addressed, amongst others, through a transfer under section 112 of the Financial Services and Markets Act 2000 ("FSMA"). Such transfer remains the primary measure to manage distressed financial institutions. The Financial Conduct Authority ("FCA") and Prudential Regulatory Authority ("PRA") reserve the right to petition the court to instigate proceedings under the Insolvency Act 1986 and Section 112 of the FSMA if necessary.[33] Under the supervision of the court, a transfer scheme entails a full or partial transfer of the business pursuant to the FSMA, including its deposits. Section 112A(2) is invoked automatically. This section stipulates that any contractual right to terminate, modify or otherwise cancel, or enforce or make a claim, is suspended. Any conflicting, purported action is rendered void. The court can only lift this suspension by way of order. This order may provide for certain continued restrictions, which will also be applicable once the general suspension has been lifted.[34] It allows the court to make further provisions to effect what it deems "necessary to secure that the scheme is fully and effectively carried out".[35] This wide-ranging power is subject to strict conditionality, requiring the court to assess necessity and proportionality. This is a recurring principle which also presides in the context of resolution. The above transfer measure will be applied *mutatis mutandis* to other insolvency and administration proceedings applicable to banks and investment banks.

4.1.3 Need to revise insolvency law

There is overwhelming consensus on the deficiencies of the pre-crisis insolvency framework. The 2007 financial crisis exposed the grave limitations of insolvency law in managing distressed financial institutions, including vulnerability to losses of confidence, unsuitability for performing critical functions and inability to ensure prompt payout of insured deposits and client assets.[36] Together these deficiencies led to a manifest loss of confidence in the financial system, resulting in wholesale and depositor bank runs, contagion and loss of access to capital markets.[37] Unsurprisingly, a resounding[38] appeal for reform in the aftermath of Northern Rock's failure underlined the need to

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32 For instance, provisional liquidation proceedings under the Insolvency Act 1986 were commenced against Bank of Credit and Commerce International SA in June 1994. Administration proceedings were instituted against some English entities of the Baring group, including Barings plc, in February 1995. ING bought most of the constituent parts of Barings for a notional amount of GDB 1 (and pledged a capped commitment to discharge liabilities up to GBP 900 million). Hence, no material services were discontinued which would have resulted in a loss of confidence. The actions that led to the demise of the institution were also fraud-related, which did not affect the financial institution's ability to continue operating once recapitalised (or transferred). Other examples include Mount Banking plc and Equatorial Corporation plc

33 See section 120 of the Banking Act 2009 and Part XXIV of the Financial Services and Markets Act 2000

34 See section 112(1) of the Financial Services and Market Act 2000

35 Section 112(1)(d) of the FSMA

36 See para 2.7 of HM Treasury, Financial Services Authority, Bank of England, *Banking reform – protecting depositors: a discussion paper* (October 2007)

37 Even though the Financial Services Compensation Scheme may provide relief, it does not preclude disruption.

38 It should be noted that the Government initially opposed the need for reform. The Lord Chancellor stated the following:

> A modified form of insolvency as a first step is unlikely to enhance consumer or market confidence, particularly in the ability of the bank to continue to meet its financial obligations. Further, it puts the bank into a governance framework that is

review existing insolvency proceedings and restructuring measures and to introduce a modified regime.[39] It was intended that such a regime should be a "stand-alone insolvency regime for banks based on existing insolvency provisions and practice".[40]

4.1.3.1 The special nature of financial institutions

Insights into the special nature, and asset and liability structure of financial institutions informed the modification of insolvency laws. Financial institutions pose significant obstacles for insolvency practicioners for the following reasons. First, they are complex in terms of capital structure, e.g. multiple entities shifting liabilities and assets within the group. Moreover, further intricacies result amongst others from subordination and various governing laws, and from conflicting insolvency law provisions depending on the *situs* of the entitites. Second, operations such as off-balance sheet transactions and financial instruments are inherently difficult to price. Third, transactions reinforce interconnection between financial institutions.[41] The complexity problem seems even more precarious considering the need for early and rapid intervention to contain the uncontrolled spreading of distress to other financial institutions, also known as contagion.[42] Simon Gleeson and Randall Guynn articulated the need for a special resolution regime and the inappropriateness of traditional company insolvency as follows:[43]

> Banks are unlike commercial companies in many ways. A fundamental difference is that whereas commercial companies produce widgets, banks produce money and credit… [I]t is a fundamental fact of their business that banks generally cannot continue to produce their financial widgets whilst insolvent. In ordinary corporate insolvency practice, it is entirely practical to allow an insolvent business to continue to produce its widgets… The essence of these approaches is that an insolvent commercial company can continue to pay commercial creditors of the firm – who are therefore prepared to continue to trade with it – whilst postponing payments to financial creditors… Treating the claims of financial creditors as subordinate to the claims of commercial creditors is justified on the ground that it results in more value for the financial creditor… [T]he distinction between commercial creditors and financial creditors is not a meaningful one for banks.

> very unlikely that of other commercial banks. Taken together, these factors could reduce the likelihood of a private sector solution…

See HM Treasury, Financial Services Authority, Bank of England, *Financial stability and depositor protection: special resolution regime* (July 2008) para 3.1, Box 3.1

The Government failed to consider the insolvency laws interaction with resolution, and the statement is premised on the idea that the modified regime will aid the rehabilitation of the "whole" financial institution. This fallacy was common during the financial crisis and in its immediate aftermath. Financial institutions themselves do not need to be rescued in their entirety, only their systemically relevant parts.

39 See HM Treasury, Financial Services Authority, Bank of England, *Financial stability and depositor protection: strengthening the framework* (January 2008)

40 Ibid paras 4.33 to 4.35

41 For an overview of the crucial role of financial institutions in the economy, see Franklin Allen, Elena Carletti, and Xian Gu, 'The roles of banks in financial systems' in Allen Berger, Philip Molyneux and John Wilson (eds) *The Oxford Handbook of Banking* (2nd edn, Oxford University Press 2015), pp. 27 sq, and for an overview of the issue of complexity of financial institutions in context of systemic risk, see Richard Herring and Jacopo Carmassi, 'Complexity and Systemic Risk; What's changed since the crisis?' in Allen Berger, Philip Molyneux and John Wilson (eds) *The Oxford Handbook of Banking* (2nd edn, Oxford University Press 2015), pp. 78 sq and John Armour, 'Making Bank Resolution Credible' in Niamh Moloney, Eilis Ferran and Jennifer Payne (eds) *The Oxford Handbook of Financial Regulation* (1st edn, Oxford University Press 2015), pp. 453 sq

42 During the crisis , rapid intervention was impossible as shareholders' and creditors' consent was often required to implement restructuring measures that were expected to lead to a recovery or could at least prevent contagion

43 Simon Gleeson and Randall Guynn, *Bank Resolution and Crisis Management; Law and Practice* (Oxford University Press 2016) pp. 5 sq

It is not suggested that failures of financial institutions should be thwarted at any cost due to the crucial role in the economy and the inability of insolvency law to manage their distress. In contrast to the special resolution regime of 2008, the general consensus among policymakers and regulators has been since the early initiatives to establish resolution regimes that the cost of an orderly liquidation should be internalised, ie funded by creditors, and extraordinary recourse to public funds avoided. Concurrently, the resilience of financial markets should be protected. Thus, it is not possible to merely consider single distressed institutions; instead, a market-wide perspective is necessary. Insolvency practitioners' perspectives need to be reconciled with financial stability objectives.[44] Such responsibility cannot be delegated to the insolvency practitioner but requires the involvement of and coordination with the BoE. Moreover, the objectives need to be recalibrated such that first all targets that serve financial stability are achieved. In other words, whereas the orientation of insolvency law in relation to ordinary companies is micro-prudential, it must be macro-prudential in relation to financial institutions.

4.1.3.2 Initiation of proceedings

Traditionally, competent authorities could initiate proceedings against distressed financial institutions upon obtaining court approval. The commencement of insolvency proceedings was solely court-sanctioned. Therefore, the post-crisis approach sought to endow competent authorities, such as central banks, ministries of finance, treasuries or supervisors, with sufficient powers to intervene before risks to financial stability would materialise or resolve distressed financial institutions, while observing the overriding objective of financial stability. Under the 2008 Act, the Treasury was empowered to nationalise certain financial institutions in order to "[maintain] the stability of the UK financial system" and "[protect] the public interest".[45] The objective of the 2008 Act is to stabilise financial institutions in part or as a whole to such an extent that they can continue operating as going concerns within the meaning of Schedule 16 of the Enterprise Act 2002 without recourse to extraordinary public support. The 2008 Act provides for extraordinary powers relating to the "authorised deposit-taker".[46] The Act, in conjunction with the Northern Rock plc Transfer Order 2008,[47] provided the Treasury with sufficient powers to establish a framework whereby Northern Rock could be partially rehabilitated under the protection of a nominee of the Treasury, BoE or a company wholly owned by the BoE or Treasury.[48]

4.1.3.3 Proceedings and measures

The 2008 Act primarily makes it possible to issue orders for the transfer and retransfer of property, rights and liabilities relating to single financial institutions within twelve months after commencent of

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44 Rodrigo Olivares-Caminal, Alan Kronberg, Sarah Paterson, John Douglas, Randall Guynn and Dalvinder Singh (eds), *Debt Restructuring* (2nd edn, Oxford University Press 2016) para. 7.08

45 The 2008 Act received Royal Assent on 21 February 2008, see 17(2) of the Banking (Special Provisions) Act 2008

46 This means any undertaking which has permission to accept deposits under Part 4 of FSMA 2000, including building societies; see sections 2 and 11 of the Banking (Special Provisions) Act 2008; the long title of the 2008 Act is "An Act to make provision to enable the Treasury in certain circumstances to make an order relating to the transfer of securities issued by, or of property, rights or liabilities belonging to, an authorised deposit-taker; to make further provision in relation to building societies; and for connected purposes"

47 No 432

48 Section 3(1) of the Banking (Special Provisions) Act 2008

the resolution measure;[49] it also contains consequential and supplementary provisions that confer unprecedented and extraordinary intervention powers. It has even been suggested that these powers endanger or undermine the "principles of the rule of law".[50] These powers are based on the premise that extraordinary times require extraordinary measures. For instance, the Treasury is empowered to (i) disapply any statutory provision or the rule of law, or (ii) make modifications to the extent it deems necessary to execute required measures.[51] Like in general insolvency, the ability to stay legal proceedings or disapply contractual rights is indispensable. During a short period, insolvency practitioners can ascertain the distressed debtor's claims and obligations, and establish a plan for its liquidation or rehabilitation. This power takes the form of a moratorium under section 12(3)(a) of the 2008 Act.[52]

For present purposes, it should be noted that parties that seek to enforce contractual rights such as those regarding credit risk mitigation techniques need to obtain the consent of the Treasury or BoE. Any purported enforcement action without such consent will be void. However, the extraterritorial effect of this measure is limited, meaning that the exercise of contractual early termination rights by foreign entities cannot be prevented. In Europe, courts can give effect to moratoria by virtue of the Credit Institutions (Reorganisation and Winding up) Regulations 2004.[53] However, since this would require the relevant insolvency practitioner or authority bringing an action, the effect on a cross-jurisdictional scale is considered inexpedient due to the time-consuming and expensive procedures. In relation to third states, recognition is based on comity or treaties. However, such recognition regimes are scarce and were unsuccessful during the financial crisis.

4.2 Insights resulting from Lehman Brothers' default

On 14 September 2008, all attempts by the Federal Reserve to rescue Lehman Brothers proved to have failed. Consequently, on the following day, due to illiquidity the group filed for bankruptcy protection under Chapter 11 of the US Bankruptcy Code. In England, administration proceedings under the Insolvency Act 1986 were opened against Lehman's European subsidiary shortly afterwards. During the proceedings it crystallised that, overall, Lehman Brothers Europe had 140,000 open trades and 1,300 prime brokerage accounts – with assets and monies held by

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49 Section 2(8) of the Banking (Special Provisions) Act 2008. For example secondary legislation includes Northern Rock plc Transfer Order 2008, SI 2008/432; Bradford & Bingley plc Transfer of Securities and Property etc Order 2008, SI 2008/2546; Bradford & Bingley plc Transfer of Securities and Property etc (Amendment) Order 2009, SI 2009/320; Heritable Bank plc Transfer of Certain Rights and Liabilities Order 2008, SI 2008/2644; Transfer of Rights and Liabilities to ING Order 2008, SI 2008/2666; Kaupthing Singer & Friedlander Limited Transfer of Certain Rights and Liabilities Order 2008, SI 2008/2674; Kaupthing Singer & Friedlander Limited Transfer of Certain Rights and Liabilities (Amendment) Order 2009, SI 2009/308; Heritable Bank plc Transfer of Certain Rights and Liabilities (Amendment) Order 2009, SI 2009/310

50 Roman Tomasic, 'The rescue of Northern Rock: nationalisation in the shadow of insolvency' (2008) Corporate Rescue and Insolvency p. 109, p. 110

51 Section 12(2) of the Banking (Special Provisions) Act 2008. This power is often referred to as the Henry VIII clause

52 Moratoria can also be applied to normal companies under para 34 of Schedule B1 to the Insolvency Act 1986. This paragraph was also applied to financial institutions before the 2008 Act was passed, see Sunay Radia, 'Re Kaupthing Singer & Friedlander Ltd (in administration) [2012] EWHC 2235 (Ch)' (2013) 10(2) International Corporate Rescue p. 129

53 SI 2004/1045

subsidiaries or third party custodians and sub-custodians. Transactions were governed by, in total, over 6,500 master agreements.[54]

It is germane to present some data to comprehend the magnitude of Lehman Brothers' failure on the financial contract market. The derivative portfolio of the Lehman Brother's group was sizeable. Its value was estimated at USD 46.3 bn and USD 24.2 bn on the asset and liability side, respectively.[55] This amount represents 30 basis points of the combined gross OTC derivatives market.[56] Regarding the notional value in relation to credit default swaps, the estimate was between USD 3.5 and 5 trillion as at 31 August 2008. The number of trades exceeded 1 million, representing about 2 percent of all outstanding positions as at the date of the default.[57]

Contrary to common perception, Lehman Brothers' default on its derivative positions did not cause the subsequent failure of its counterparties.[58] To the contrary, the value of in-the-money positions exceeded USD 31 bn in November 2007.[59] In fact, "[t]his fear proved to be vastly overstated" as Hale Scott noted.[60] Presumably, the ramifications were overstated due to the focus on the notional value.[61] The estimate did not consider the effect of close-out netting. Close-out netting has been credited with militating against Lehman's default. Problems that arose as a result of Lehman Brothers' default in relation to financial contracts can be ascribed to failures to execute the rights under the master agreements and to technical errors. For instance, the following major weaknesses represented substantial challenges:[62]

(i) flawed negotiated documentation;

(ii) harsh and 'easy to fall foul of' termination notice provisions;

(iii) difficulties in enforcing close-out;

(iv) weaknesses in the market quotation mechanisms and fall-backs in a distressed market;

(v) lack of agreed level of detail in calculation statements; and

(vi) lack of infrastructure for counterparties dealing with defaults.

However, consensus in practice was that the risk allocation achieved by the master agreements was overall successful. ISDA was quick to remediate any problems by preparing, amongst others, protocols. If adhered to by both parties, these protocols can amend the master agreement to meet new regulatory requirements and remediate contractual deficiencies.

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54 See Gregory Mitchell, 'Proprietary claims and Lehman Brothers' (2009) 2 Journal of International Banking and Financial Law 59

55 Hale Scott, *Connectedness and Contagion* (MIT Press 2016) p. 35

56 Ibid

57 Ibid

58 Ibid

59 Simon Firth, 'The English law Treatment of Lehman's Derivatives Positions' in Dennis Faber and Niels Vermunt (eds) *Bank Failure: Lessons from Lehman Brothers* (Oxford University Press 2017) para 10.1

60 Hale Scott, *Connectedness and Contagion* (MIT Press 2016) p. 35

61 The notional value is not informative and does not reflect the real exposure. The real exposure is the gross exposure, without taking the reducing effect of close-out netting into account. It is worth reiterating that the net exposure is merely 40 per cent of the gross exposure

62 Edmund Parker and Aaron McGarry, 'The ISDA Master Agreement and CSA: Close-out Weaknesses Exposed in the Banking Crisis and Suggestions for Change' (2009) 24(1) Journal of International Banking and Financial Law p. 16, p. 16

4.3 Regulatory concepts and the assessment of risk

This section provides an overview of how regulatory concepts and the assessment of risk have changed due to the financial crisis. First, it introduces the prudential perspective hinging on the premise that overall stability of the financial market is the result of the stability of each financial institution. Second, it discusses the interconnection between financial institutions which has often been falsely ascribed to financial contracts. Overall, this section will seek to elucidate key notions and allocations of risk.

4.3.1 Prudential perspectives

Although the term "prudential perspective" connotes supervision, it is used in a broader context as an appreciation of risk inherent in the financial system. The discussion below analyses two prudential concepts, i.e. the micro-prudential and the macro-prudential perspective.[63] The primary difference is that the micro-prudential perspective concerns single financial institutions, while the latter relates to the interaction between financial institutions and additional factors.[64] One widely shared lesson of the crisis is that financial supervision and regulation need to become much more "macro-prudential" (rather than remaining "micro-prudential"), that is, they should be geared towards containing systemic risk (rather than to the risks posed by individual intermediaries or markets).[65] In particular, certain mechanisms that are deemed beneficial on an individual level could act as a risk channel or even as amplifiers on a macro-prudential level.[66]

4.3.1.1 Micro-prudential perspective

The micro-prudential perspective is premised on the conjecture that the financial system's stability is the result of the resilience of single financial institutions. As a consequence, the flawed conclusion prevailed that as long as market participants can manage the systemic dimension via master agreements, imposing capital requirements will be sufficient. Capital requirements serve to absorb shocks caused by adverse events, thereby promoting the viability of financial institutions.[67] In a similar vein, policymakers and regulators ascribed crucial importance to financial risk management measures, including credit risk mitigation techniques.[68] This resulted in a tiled perspective that disregarded risks stemming from increased interconnections and from market practice endorsing credit risk mitigation techniques.[69] According to micro-prudential understanding, market participants

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63 See Claudio Borio, 'Rediscovering the Macroeconomic Roots of Financial Stability Policy: Journey, Challenges, and a Way Forward' (2011) 3 Annual Review of Economics p. 87. On the Regulation of systemic risk see Iman Anabtawi and Steven Schwarcz, 'Regulating Systemic Risk: Towards an Analytical Framework' (2011) 86 Notre Dame Law Review p. 1349

64 Céline Gauthier, Alfred Lehar and Moez Souissi, 'Macroprudential Capital Requirements and Systemic Risk' (2012) 21 Journal of Financial Intermediation p. 594, 597

65 Olivier de Bandt, Philipp Hartmann and José-Luis Peydró, 'Systemic risk in banking after the great financial crisis' in Allen Berger, Philip Molyneux and John Wilson (eds) *The Oxford Handbook of Banking* (2nd edn, Oxford University Press 2015) p. 667, p. 668

66 Stijn Claessens, Giovanni Dell'Ariccia, Deniz Igan and Luc Laeven, 'Lessons and policy implications from the global financial crisis' (2010) International Monetary Fund Working Paper No. WP /10/44

67 Michael Schillig, Resolution and Insolvency of Banks and Financial Institutions (Oxford University Press 2016) p 41

68 These also concern risk management, governance, and risk culture, see Peter Mülbert, 'Managing Risk in the Financial System' in Niamh Moloney and Eilís Ferran (eds) *The Oxford Handbook of Financial Regulation* (1st edn, Oxford University Press 2015) pp. 370 sq

69 The Basel Committee identified a list of risks that can cause failures of financial institutions, see Basel Committee on Banking Supervision, *Core Principles for Effective Banking Supervision* (2012)

are expected to behave similarly in order to operate most efficiently. Given the widespread use of master agreements and credit risk mitigation techniques, it can be inferred that reliance on master agreements and credit risk mitigation techniques supports a micro-prudential notion. Goodhart states that this became quite clear during the financial crisis; however, the side effect is that uniform behaviour amplifies distress.[70] Goodhart argues that

> [s]elf-similarity, on the "best", will, indeed, strengthen those involved, in particular the banks, against idiosyncratic shocks — but, by reducing diversity, will actually weaken the system as a whole against general systemic shocks.[71]

This effect is described as the structural dimension[72] of systemic risk.[73] The structural dimension relates to the risk distribution amongst financial institutions.[74] First, due to overreliance on securities financing transactions governed by multiple master agreements containing similar credit risk mitigation techniques, the initial shock of the distress was augmented. This led to uniform behaviour that, in its entirety, weakened distressed parties by creating a run-like response. Second, due to interdependencies amongst credit mitigation techniques including cross-default, whereby indirectly related transactions were terminated, a default on one instrument rapidly culminated into the default of other instruments and had the propensity to affect other group entities. It is not suggested, however, that the use of financial contracts and credit risk mitigation techniques should be restricted due to their beneficial function in relaion to risk and liquidity management as described in previous chapters. It is essential to consider the market conditions. Competent authorities should take account of the interrelations and interdependencies of the financial system. Whereas the micro-prudential perspective endorsed unrestricted use of financial contracts and credit risk mitigation techniques, it is advocated that in certain circumstances competent authorities should take a more proactive approach. They should give priority to financial stability by promoting resilience. Inevitably, this requires a change of perspective, namely to a macro-prudential perspective that warrants limited suspension of terminationrights, thereby promoting financial stability. .

Principles 17-25, see Phoebus Athanassiou, 'The role of Regulation and supervision in crisis prevention and management: a critique of recent European reflections' (2009) 24(10) Journal of International Banking Law and Regulation p. 501

70 Charles Goodhart, 'Linkages between macro-prudential and micro-prudential supervision' (2015) 10 Journal of International Banking & Financial Law p. 607

71 Ibid

72 Also referred to as the cross-sectional dimension of systemic risk. It is "understood as the allocation of systemic risk (its sources) in the financial system at a given moment; it includes risks to financial stability arising from, i.a. instability of particular institutions, concentration (similarities) of their risk exposure or funding sources, size, structure and concentration level of the financial system and the links (direct and indirect) between financial institutions", see Paweł Smaga, 'The Concept of Systemic Risk' (2014) London School of Economics SRC Special Paper No 5 p. 9

73 See Anat Keller, 'The mandate of the European Systemic Risk Board and resilience as an essential component: Part 1' (2016) 31(1) Journal of International Banking Law and Regulation p. 13 and Claudio Borio, 'Implementing a macro-prudential framework: Blending boldness and realism' (2011) 6 Capitalism and Society; Alastair Clark and Andrew Large, 'Macroprudential policy: addressing the things we don't know' (2011) Group of Thirty Occasional Paper 83. See also Piet Clement, 'The Term "Macroprudential": Origin and Evolution' (March 2010) BIS Quarterly Review.

74 Developed by network theories such as set out in Frank Allen and Ana Babus, "Networks in Finance" in Paul Kleindorfer, Yoram Wind, Robert Gunther (eds) The Network Challenge: Strategy, Profit and Risk in an Interlinked World (Upper Saddle River: FT Press, 2008); Prasanna Gai, Andrew Haldane and Sujit Kapadia, 'Complexity, Concentration and Contagion' (2011) 58 Journal of Monetary Economics.

4.3.1.2 Macro-prudential perspective

The financial crisis of 2007 led to increased awareness of the importance of the interaction between financial market participants.[75] Brunnemeier et al. coined the term "fallacy of composition", describing the fallacy that systemic stability is the "aggregate" of single institution stability as promoted by the micro-prudential perspective.[76] The previous paragraph refuted this presumption. Another fallacy rests on the assumption that resilience is static. Georgosouli argued that the notion ought to be dynamic.[77] She inferred that resilience is based on the "adaptive capacity to change". This ability refers to the variations in capital charges according to changes in the risk-weighted assets and countercyclical buffers under the CRR. Pursuant to this dynamic notion, financial institutions and regulators must be prepared for, learn from and anticipate adverse developments and execute measures that can facilitate recovery.

In fact, commentators and policymakers often advocate that the aim of macro-prudential supervision must be shaped by considering resilience. This concept is inextricably associated with financial stability and averting systemic risk. However, discussions on the meaning and form of the resilience concept in the context of macro-prudential policy are rare.[78] The market resilience of financial contracts can be supported by the developing robust market infrastructures and crisis management procedures under the European Market Infrastructure Regulation. However, the resilience of the system of financial institutions and financial market participants must necessarily also be a priority.[79] In other words, financial stability or the prevention of systemic risk hinges on the notion of resilience.

Resilience, due to its dynamic aspect, is not necessarily sufficiently addressed by supervision. [80] Regulatory intervention to promote resilience should not be confined to mere recovery of the financial institution. Priority must be given to maintaining fundamental infrastructures and services provided by the relevant financial institution. Resilience does not necessitate the recovery of failing institutions, but rather the continuance of fundamental services provided to the financial markets and depositors.

4.3.2 Systemic stability and systemic risk

It is germane to explore whether the notion of financial stability should act as a mandatory principle of law capable of overriding contractual provisions. At the outset, it should be noted that the distinction between public and private law blurs in regulation.[81] An overriding mandatory provision

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75 Maria Elena Salerno, 'The renewed objectives of financial Regulation after the global financial crisis' (2015) 30(6) Journal of International Banking Law and Regulation p. 315

76 Markus Brunnermeier, Andrew Crocket, Charles Goodhart, Avinash Persaud and Hyun Shin, 'The Fundamental Principles of Financial Regulation' (2009) Geneva Reports on the World Economy p. 11

77 Andromachi Georgosouli in Rosa Lastra, 'Systemic risk and macro-prudential supervision' in Niamh Moloney and Eilís Ferran (eds) *The Oxford Handbook of Financial Regulation* (1st ed., Oxford University Press 2015) pp. 310 sq

78 Joanna Gray, 'Towards a More Resilient Financial System?' (2013) 36 Seattle University Law Review p. 799

79 Graeme Baber, 'Peer review of financial stability: how does the United Kingdom fare?' (2014) 35(3) Company Lawyer

80 Benjamin Geva, 'Systemic risk and financial stability: the evolving role of the central bank' (2013) 28(10) Journal of International Banking Law and Regulation p. 403

81 André Berends, 'Why Overriding Mandatory Provisions that Protect Financial Stability Deserve Special Treatment' (2014) 61 Netherlands International Law Review p. 69, p. 71

limiting free choice of governing law and restricting exemptions from mandatory laws must be well-reasoned. Another approach is to permit limited derogation. In case of financial contracts, derogation must be primarily based on solid grounds promoting financial stability, for instance by ensuring that financial markets are not exposed to extensive shocks arising from a default which could give raise transgress the institution and affect other entities. These grounds must be sufficiently concrete as to prevent arbitrariness.

Reflecting on the events that unfolded with Lehman's insolvency, Martin Hellwig described the breadth of effects falling within the understanding of systemic risk and its consequences:

> All the effects that economists could think of under the heading of "systemic risk" had been turned loose: There were immediate domino effects on Lehman counterparties, money market funds holding Lehman debt … as well as AIG being involved in credit default swaps …. Markets where Lehman had acted as market maker were disrupted by Lehman's no longer serving this function. Repo lenders to Lehman had difficulties in disposing of, or refinancing, collaterals. Through information contagion, this effect spread across repo markets, causing these markets to shut down completely … Through information contagion, the lesson that a large bank might not be bailed out with public money also affected confidence in other banks. Without confidence of banks in each other, interbank markets came to a virtual standstill.[82]

Yet, there is no evidence of such a domino effect due to bilateral agreements. Lehman Brothers had a significant role in the CDS market. Given that its services were discontinued, there were significant disruption. However, this is a problem of a concentrated market such as monoploy or oligopoly, but not related to bilateral transactions. This illustrates the extent of the understanding of systemic risk and its effects. Simultaneously, it points to a vast array of potential causes. Regulatory reform requires a certain amount of certainty to justify imposing new onerous requirements or expanding regulators' authority.[83] The following sections aim to establish a more tangible definition of systemic risk, within the context of financial contracts.

4.3.2.1 Definition

During the financial crisis but also in its aftermath, policymakers and commentators attempted to define and quantify systemic risk – an exercise which proved challenging.[84] The term "systemic risk" has no generally accepted, univocal and objective definition.[85] An exemplary definition is set out in

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82 Martin Hellwig, 'The problem of bank resolution remains unsolved: A critique of the German ban restructuring law' in Patrick Kenadjian (ed) *Too Big To Fail – Brauchen wir ein Sonderinsolvenzrecht für Banken?* (De Gruyter 2012) p. 36

83 Peter Yeoh, 'The challenges and implications of systemic risks for financial regulation' (2010) 31(12) Company Lawyer p. 389

84 For a policymaker's perspective see International Monetary Fund, *Responding to the Financial Crisis and Measuring Systemic Risk; Global Financial Stability Report* (2009), p. 113 and Matthias Drehmann and Nikolas Tarashev, 'Systemic Importance: Some Simple Indicators' (2011) March BIS Quarterly Review p. 26; for an academic perspective see Stijn Claessens, Richard Herring and Dirk Schoenmaker, 'A Safer World Financial System: Improving the Resolution of Systemic Institutions' in Geneva Reports on the World Economy (2010) No 12 (Centre for Economic Policy Research, 2010) p. 18, Adam Levitin, 'In Defense of Bailouts' (2011) 99(2) Georgetown Law Journal p. 443 and Oliver Bandt and Philipp Hartmann, 'Systemic Risk in Banking: A Survey' in Charles Goodhardt and Gerhard Illing (eds) *Financial Crises, Contagion, and the Lender of Last Resort; A Reader* (Oxford University Press 2002) p. 249

85 Paweł Smaga, 'The Concept of Systemic Risk' (2014) London School of Economics SRC Special Paper No 5 and Peter Mülbert, 'Managing Risk in the Financial System' in Niamh Moloney and Eilís Ferran (eds) *The Oxford Handbook of Financial Regulation* (1st edn, Oxford University Press 2015) pp. 381

the Regulation establishing the European Systemic Risk Board,[86] namely the risk of "disruption to financial services caused by a significant impairment of all or parts of the … financial system that has the potential to have serious negative consequences for the … market and the real economy". This definition suggests that the risk also encompasses the initial shock. Another approach to defining systemic risk would be to consider only the second limb, i.e. the risk that the shock affects other financial institutions and the real economy. For instance the Bank of England Act 1998 defines systemic risk a"a risk to the stability of the UK financial system as a whole or of a significant part of the that system".[87] It includes risk attributable to (i) structural features such a connection between institutions,[88] (ii) distribution of risk within the financial sector and (iii) unsustainable levls of leverage, debt or credit growth.[89]

The generally accepted definition of systemic risk was developed by the International Monetary Fund in conjunction with the Bank for International Settlement and Financial Stability Board: Systemic risk is the "disruption to the flow of financial services that is (i) caused by an impairment of all or parts of the financial system; and (ii) has the potential to have serious negative consequences for the real economy".[90] This definition necessarily blurs the micro- and macro-prudential perspective. In the discussion below, systemic risk is defined as the risk that a disruption of the financial markets may cause "serious" ramifications for the financial system and real economy.

The causes of systemic risk are also wide-ranging.[91] The inherent complexity and interconnectedness of financial institutions significantly contribute to the vulnerability of the financial system.[92] The rationale of this statement is that complexity precludes the rehabilitation and resolvability of distressed financial institutions, while interconnectedness enhances the radiation of distress. Both characteristics reinforce the propensity of shocks to impact single financial institutions, especially those providing an essential function within the financial system, to spread and affect surrounding institutions. If this shock evolves unhindered, the consequence may lead to the default of other financial institutions (and asset managers and insurance companies) – a process also referred to as contagion.

4.3.2.2 Vectors of risk and distress

Relations with other financial market participants or market values, either direct or indirect, have been pinpointed as being among the major contributors to the severity of financial crises.[93] These relations

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86 Regulation No 1092/2010. Systemic risk is the risk that a disruption of the financial markets may cause "serious" ramifications for the financial system and real economy, see Art 3(1)(10) of Directive 2013/36/EU (Capital Requirements Directive IV or "CRD IV")

87 Section 9C(5) of the Bank of England Act 1998

88 See Section 4.3.2.2

89 Section 9C(3) of the Bank of England Act 1998

90 International Monetary Fund, Bank for International Settlements and Financial Stability Board, *Guidance to Assess the Systemic Importance of Financial Institutions, Markets and Instruments: Initial Considerations* (2009) pp. 5-6 www.bis.org/publ/othp07.pdf <accessed on 31 January 2016>

91 See Peter Mülbert, 'Managing Risk in the Financial System' in Niamh Moloney and Eilís Ferran (eds) *The Oxford Handbook of Financial Regulation* (1st edn, Oxford University Press 2015) pp. 382

92 Cf. Wim Fonteyne, Wouter Bossu, Luis Cortavarria-Checkley, Alessandro Giustiniani, Alessandro Gullo, Daniel Hardy and Seán Kerr, 'Crisis Management and Resolution for a European Banking System' (2010) IMF Working Paper WP /10/70, p. 10

93 Zijun Liu, Stephanie Quiet and Benedict Roth, 'Banking sector interconnectedness: What is it, how can we measure it and why does it matter?' (2015) Bank of England Quaterly Bulletin Q2

can come in various forms. Direct exposures, such as those arising from financial contracts, spring to mind. Such relations can channel and spread risk. Therefore, the most notorious causes of distress and relevant relationships should be explored. These are connectedness, contagion and correlation, which are discussed below.

(a) Connectedness

Asset connectedness relates to the failure of a financial institution which causes a chain default among other directly connected financial institutions.[94] It resembles what has become widely known as contagion. Scott asserts that this notion did not materialise during the financial crisis.[95] He states that even the losses of Lehman Brothers were not sufficient to "push" connected firms into insolvency.[96] To reiterate, it was primarily the discontinuation of essential services (as will be discussed below)Asset connectedness may, for instance, arise if a credit institution has an excessive exposure to an investment firm. As a corollary of the investment firm's default, the credit institution fails, thereby causing the failure of a third institution connected to the credit institution. There is wide consensus that asset connectedness cannot result in financial crisis.[97] This implies that massive derivatives exposures are not likely to cause interdepent insolvencies either.

Another form of connectedness is liability connectedness, which arises from the default of a provider of short-term funding, if the recipient relies excessively on the provider for its liquidity. As seen above, repos and securities lending agreements are widely used to manage liquidity. Literature finds, again, that liability connectedness cannot be the cause of systemic risk;[98] this conjecture is corroborated when considering the transactions of Lehman Brothers.

(b) Contagion

Scott claims that the cause of the financial crisis, or at least an extensive component, was contagion.[99] Contagion means the irrational, run-like behaviour.[100] Propagated by fear, contagion can spread and cause the termination of transactions, thus reducing aggregate market liquidity.[101] "The problem is of hoary vintage".[102] In contrast to the connectedness described above, contagion does not discriminate between financial institutions; it arises from a general fear that is not

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94 See Michael Shilling, *Resolution and Insolvency of Banks and Financial Institutions* (Oxford University Press 2016) pp. 41 sq

95 Hale Scott, *Connectedness and Contagion* (MIT Press 2016) p. 3

96 Ibid

97 Paweł Smaga,'The Concept of Systemic Risk' (2014) Systemic Risk Centre Paper No 5 p. 10 sq and Lukasz Prorokowski, 'Lessons from financial crisis contagion simulation in Europe' (2013) 30(2) Studies in Economics and Finance p. 159

98 Paweł Smaga,'The Concept of Systemic Risk' (2014) Systemic Risk Centre Paper No 5 p. 10 sq

99 See also Thomas Moser, 'What Is International Financial Contagion?' (2003) 6(2) International Finance p. 157, pp. 162 to 166

100 Mark Roe, 'The derivatives market's payment priorities as financial crisis accelerator' (2011) 63 Stanford Law Review p. 539, p. 567

101 HM Treasury, *Banking Act 2009: Special resolution regime code of practice* (revised March 2017) para 3.9, see Caroline Van Rijckeghem and Beatrice Weder, 'Sources of Contagion: Is it Finance or Trade?' (2011) 54 Journal of International Economics p. 293 and Graciela Kaminsky and Carmen Reinhart, 'On Crises, Contagion, and Confusion' (2000) 51 Journal of International Economics p. 145, p. 154

102 Hale Scott, *Connectedness and Contagion* (MIT Press 2016) p. 5

counterparty-specific.[103] Thus, even independent financial institutions can be affected to a similar extent. The cause is excessive reliance by financial institutions on short-term funding. Securities lending transactions often include an on-demand right to withdraw the funding.[104] This produces an almost immediate obligation to return the security.[105] Repos have a shorter maturity and are extended on the same terms for another period.[106] Ostensibly, after expiration of this period, the liquidity provider will seek to withdraw the liquidity.[107]

It can be argued that there is no need for such termination since the transaction is collaterised or margined. During the financial crisis, the value of asset prices fell so sharply that the collateral or margin maintenance obligation could not be honoured.[108] Failure to maintain the collateral or margin can also trigger an event of default. Upon return of the securities, financial institutions in need of liquidity must sell them or substitute them for more liquid instruments. A market-wide sale of assets, due to lack of demand, can further depress the asset value, because the distressed financial institutions need to sell the assets at a substantial discount to meet the reduced demand. This depressed asset value can propagate the distress – in particular, if the assets constitute security. Similarly, other industries may be affected as the withdrawal of funds is primarily aimed at satisfying own liquidity needs. This point marks the spill-over to the economy.

Transparency is crucial to prevent such irrational behaviour. Furthermore, if parties can ensure that their transactions will be honoured, there is no need to engage in a run. Equally important is to regulate the funding structure and limit overreliance on short-term funding. Limiting the use of financial contracts cannot be the response. It is essential for regulation or resolution not to increase the risk to financial contracts. Interestingly, there is no evidence to that effect in the literature.[109] Most studies concern correlation, as will be explored below. In the absence of evidence, however, the regulator operates, to a certain degree, in the dark. Hence, regulatory responses are intuitive but not persuasive. Nonetheless, this section highlights the importance of securities financing transactions for liquidity management.

(c) Correlation

Correlation means the failure of various financial institutions due to depressed asset prices,[110] which means that the prices do not reflect the assets' real, intrinsic values. Financial bubbles, a concept describing an overvaluation of assets with a rapid correction, are often associated with this notion. In the context of financial distress, this correlation can also be caused by a fire sale of assets. It is intuitive that a sudden oversupply will be followed by a reduction in price to meet the constant

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103 Arvind Krishnamurthy, 'Amplification mechanisms in liquidity crises' (2010) 2(3) American Economic Journal: Macroeconomics p. 1 and Mark Roe, 'The derivatives market's payment priorities as financial crisis accelerator' (2011) 63 Stanford Law Review p. 539

104 See section 1.2.2.2

105 For instance, overnight or within three days depending on the master agreement used

106 In financial circles, the extension is referred to as rollover

107 See Joanna Benjamin, 'Lessons of LBIE: Reuse and rehypothecation' in Dennis Faber and Niels Vermunt (eds) *Bank Failure: Lessons from Lehman Brothers* (Oxford University Press 2017) paras 9.01 sq, and paras 9.242 sq

108 See 4.3.2.2(c) for the reason behind the sharp decline in asset prices

109 Hale Scott, *Connectedness and Contagion* (MIT Press 2016) p. 14

110 See Nigel Jenkinson, 'Containing system-wide liquidity risks: some issues and challenges' (2009) 10(3) European Business Organization Law Review p. 387, p. 397

demand.[111] Such deterioration of asset prices may further worsen the situation of the financial institution, which will receive less for its assets. Due to the urgency to meet its obligations, the financial institution's options will be limited. Other financial market participants holding the same or similar assets, which can act as substitute, or financial contracts referencing to such assets, will indirectly experience distress.

4.4 International development

The experience of the 2007 crisis suggests that a resolution regime for financial institutions should not solely aim at facilitating the distribution of assets to creditors and shareholders as is the case of traditional insolvency law. A financial institution recovery and resolution framework should achieve "regulatory objectives that are vital to the efficient operation or the economy".[112] This insight led to global consensus on the need for a special resolution regime.[113] Such a regime should provide resolution authorities with powers to intervene so as to avert further distress or facilitate consequent insolvency proceedings or restructuring measures. In particular, ramifications could be seen to transcend beyond distressed financial institutions if the measures applied were inadequate. The notion of systemic stability rationalises regulatory intervention. Formerly, insolvency practitioners, with the assistance of courts, could intervene only once proceedings had been commenced. However, resolution is not be predicated on the commencement of formal proceedings. Another novelty is the mandatory reduction of claims, thereby allocating losses to creditors which serves the funding of the resolution measure. This reduction is deemed inevitable in hypothetical insolvency proceedings or restructuring measures. These conceptual changes to crisis management are not unique but form part of a realignment of prudential regulatory emphasis. Before the financial crisis, a significant shortcoming was the absence of appreciation of the concept of systemic risk and its elements.[114]

In Pittsburgh in September 2009, the G20 heads of states gathered for the third time since the onset of the financial crisis to discuss financial markets and the world economy.[115] Based on a review of existing resolution regimes and insolvency law applicable to large systemically important financial institutions, a consensus formed regarding the need to develop a new framework.[116] In fact, such

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111 See Espen Eckbo and Karin Thorburn, 'Automatic bankruptcy auctions and fire-sales' (2008) 89(3) Journal of Financial Economics p. 404; Viral Acharya, Sreedhar Bharath and Anand Srinivasan, 'Does industry-wide distress affect defaulted firms? Evidence from creditor recoveries' (2007) 85(3) Journal of Financial Economics p. 787; Florian Heider, Marie Hoerova, Cornelia Holthausen, 'Liquidity hoarding and interbank market rates: The role of counterparty risk' (2015) 118(2) Journal of Financial Economics p. 336; and Joshua Coval and Erik Stafford, 'Asset fire sales (and purchases) in equity markets' (2007) 86(2) Journal of Financial Economics p. 479

112 Kern Alexander, 'Bank Resolution Regimes: Balancing Prudential Regulation and Shareolder Rights' (2009) 9(1) Journal of Corporate Law Studies p. 61, p. 62

113 Following the financial crisis, various reform initiatives sought to establish a more resilient and stable financial market. These initiatives can be divided into two categories, namely structural reform such as ring-fencing (see Financial Services (Banking Reform) Act 2013) and non-structural reform such as resolution (further discussed below)

114 Luc Laeven, Lev Ratnovski, and Hui Tong, 'Bank Size and Systemic Risk' (2014) IMF Staff Discussion Note SDN/14/04 pp. 19 sq

115 Leaders' Statement, G20 Pittsburg Summit, September 2009

116 Financial Stability Board, Key Attributes of Effective Resolution Regimes for Financial Institutions (2011 as amended in 2014)

significant adverse events justify significant reform and the regulatory regime.[117] The objective of the far-reaching 'reform agenda' is to prevent and mitigate the adverse effects of failure of financial institutions and to reduce moral hazard.[118] Since the summit's authority is limited to a general pledge to, in each member state, to achieve the common objective, the preparation of the envisaged framework needed to be delegated.

4.4.1 The Financial Stability Board and the Cross-Border Resolution Framework

At a global, conceptual level, the Financial Stability Board ("FSB") was a pivotal authority.[119] In fact, the nascence of the FSB institutionalised the focus on the development of a global resolution framework;[120] from the very beginning, the FSB has been at the apex of the design, coordination and monitoring of the implementation process. The debut task was to identify impediments to cross-jurisdictional resolution. Similarly, the Basel Committee's Cross-Border Bank Resolution Group, as part of the Basel Committee on Banking Supervision, was mandated by the Bank for International Settlements to analyse financial institution regimes and make recommendations for improvements in the areas of cooperation between and resolution of financial institutions with cross-jurisdictional operations in 2007. The result was the Committee's "Report and Recommendations of the Cross-Border Bank Resolution Group",[121] which was drawn up together with the FSB's predecessor, i.e. the Financial Stability Forum, and complemented its "Principles for Cross-Border Cooperation on Crisis Management".[122]

4.4.2 Revision of the term "resolution"

Financial institution resolution describes the restructuring of a financial institution such that critical functions are continued.[123] In its traditional meaning, resolution is the process of liquidating a financial institution to repay its insolvency creditors.[124] However, after the 2007 financial crisis a new perspective emerged, i.e. that systemically critical functions should be maintained. It applies foremost to deposit-taking institutions which provide liquidity to the real economy. The BRRD's recitals suggest that resolution seeks to replicate the effects of insolvency. Although the BRRD observes the accepted principles of insolvency law, its overriding objective is to safeguard financial

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117 Michael Shilling, Resolution and Insolvency of Banks and Financial Institutions (Oxford University Press 2016) p 15

118 For other consequences see Miguel Virgós and Francisco Garcimartín, 'Close-out netting, Insolvency and Resolution of Financial Institutions in the EU: A Conflict of Laws Analysis' in Bernard Santen and Dick van Offeren (eds) Perspectives on International Insolvency Law: A Tribute to Bob Wessels (Kluwer 2014); also Philipp Paech, 'Preliminary Draft Report on the Need for an International Instrument on the Enforceability of Close-out Netting in General and in Context of Bank Resolution' (2011) Unidroit 2011 S 78 – Doc 2, 39-72

119 International Monetary Fund and World Bank, An overview of the legal, institutions, and regulatory framework for bank insolvency (2009); International Monetary Fund, *Resolution of cross-border banks – A proposed framework for enhanced coordination* (2010)

120 See Bob Wessels, 'Giving legal effect to foreign resolution measures in the financial sector' (2015) 28(3) Insolvency Intelligence p. 44

121 Bank for International Settlements, *Report and recommendations of the Cross-border Resolution Group* (2010) prepared by the Basel Committee on Bank Supervision

122 Financial Stability Forum, FSF Principles for Cross-border Cooperation on Crisis Management (2009)

123 For instance in 2009 the IMF described this undertaking as "bank restructuring", see IMF, *An overview of the Legal, Institutional, and Regulatory Framework for Bank Insolvency* (April 2009)

124 See Sven Schelo, *Bank Recovery and Resolution* (Wolters Kluwer 2015) p. 77

stability.[125] On balance, resolution represents a compromise or a pragmatic solution to insolvency law's inability to manage distressed financial institutions.[126] In contrast to insolvency, resolution is an administrative, non-judicial procedure empowering a resolution authority to restructure distressed financial institutions, including the right to interfere with the rights of creditors and shareholders.[127] This framework should isolate systemically relevant functions of financial institutions and safeguard their continuity while ensuring that functions and services deemed irrelevant can be subject to ordinary or modified insolvency proceedings.

4.4.3 European Resolution Framework

The European resolution framework differs from the English to the extent that it contains an additional layer for certain financial institutions that are located in the Eurozone, namely the Single Resolution Mechanism ("SRM"). Therefore, it is necessary to describe the BRRD and SRM, in the first and second subsection, respectively. Their exact interaction is discussed in the third sub-section.

4.4.3.1 Bank Recovery and Resolution Directive

The BRRD established the European framework for managing distressed financial institutions.[128] It facilitates the process of introducing a harmonised regime promoting the execution of rehabilitation measures or the rapid dissolution of distressed financial institutions operating on a cross-jurisdictional basis. The legislative process, however, despite the pressing need for this regime, faced substantial obstacles. The aftermath of the financial crisis revealed that European Member States insist on the superiority of their insolvency laws[129] and challenge EU proposals resulting in substantive amendments, amongst others, on the grounds of EU principles such as proportionality and subsidiarity.[130] Consequently, the EU legislator chose to introduce its crisis management regime

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125 See Recitals 5 and 45 of the BRRD; Michael Schillig, *Resolution and Insolvency of Banks and Financial Institutions* (Oxford University Press 2016) pp. 61 sq

126 Ibid pp. 54 sq; Jens-Hinrich Binder, 'Durchsetzung von Marktdisziplin mittels zwangsweiser Übertragung systemrelevanter Teile von Banken?', Jahrbuch für die Ordnung von Wirtschaft und Gesellschaft 64 (2013), p. 387

127 Hodge Malek QC and Sarah Bousfield, 'Bad banks and the "No Creditor Worse Off" compensation scheme' (2016) Journal of International Banking and Financial Law and Victor de Serière and Daphne van der Houwen, '"No creditor worse off" in case of bank resolution: food for litigation?' (2016) 31(7) Journal of International Banking Law and Regulation p. 376

128 Directive 2014/59/EU. The BRRD's scope encompasses financial institutions such as credit institutions, including building societies, and certain investment firms as defined in Art 4 of Regulation 575/2013 ("CRR"). Certain investment institutions that do not meet the CRR's requirements are governed by Directive 2004/39/EU ("MiFID")

129 Heidi Mandanis Schooner, 'Bank insolvency Regimes in the United States and the United Kingdom' (2004 -2005) 18 The Transnational Lawyer p. 393 ("Schooner") and Adrienne Coleton, 'Banking insolvency regimes and cross-border banks - complexities and conflicts: is the current European insolvency framework efficient and robust enough to effectively resolve cross-border banks, can there be a one size fits all solution?' (2012) 27(2) Journal of International Banking Law and Regulation p. 63 ("Coleton")

130 See Official Journal of the European Union C 306 pp 150 sq. The principle of subsidiarity requires that the proposed objectives cannot be realised satisfactorily by Member States neither at central nor at regional level. Inevitably Member States will need to be assessed for their ability to fulfil the objectives, which will require a complex and time-consuming analysis, since there will be a variety of evolving aspects. The financial crisis of 2007 also highlighted that coordination is essential for the effective execution of crisis management measures, see Simon Grieser, Christian Alexander Mecklenburg-Guzman and Janine Schenk, 'Europäische Regulierung zur Bankenrestrukturierung' in Simon Grieser and Manfred Heemann (eds) *Europäisches Bankaufsichtsrecht* (4th edn, Frankfurter School Verlag 2015), pp. 973 sq

by way of primary legislation, i.e. as a directive.[131] The BRRD introduced a resolution regime requiring negligible amendments to national insolvency laws. The constellation allows considering resolution as a regime separate from insolvency. It is often suggested that resolution merely seeks to avert insolvency. If insolvency cannot be averted, resolution ensures that insolvency measures and restructuring proceedings can be applied by separating systemically relevant parts.

4.4.3.2 Single Resolution Mechanism

In conjunction with the BRRD, the Commission pursued another legislative initiative, namely the establishment of a SRM. This mechanism envisages that a single body, the Single Resolution Board ("SRB"), coordinates not only the resolution planning but also the resolution measures. The SRB's jurisdiction is limited those credit institutions in the Eurozone that are either supervised by the European Central Bank ("ECB"), have significant cross-jurisdictional operations, or are significant for the economy of the respective Member State.[132] Whereas the BRRD applies to credit institutions[133] and investment firms[134],[135] the SRM's scope is aligned with that of the Single Supervisory Mechanism ("SSM").[136] Consequently, the SRB's jurisdiction limited to certain "significant"[137] credit institutions established in the Eurozone or in a Member State which has ratified a close cooperation agreement.[138] In particular, credit institutions, investment firms and other financial institutions which form part of the group which are supervised on a consolidated basis and subject to the European Central Bank's supervision[139].[140] Consequently, the SRB has no jurisdiction

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131 Under European law, directives need to be transposed into national law in order to become effective. This allows national legislators to adapt the EU regime to its national requirements. In contrast, regulations achieve more harmonisation as they have direct effect; however, the legislative procedure is more cumbersome. The legal basis for both types of legislation is Art 114(1) of the Treaty on the Functioning of the European Union, whereby the European Parliament and European Commission, pursuant to the ordinary legislative procedure after consultation of the Economic and Social Committee, can introduce measures for the approximation of national provisions concerning the establishment and functioning of the internal market. It does not provide for the right to interfere with national substantive law but is considered a mechanism that facilitates convergence "across different jurisdictions", see Pieter Van Cleynenbreugel, 'Meroni circumvented? Article 114 TFEU and EU regulatory agencies' (2014) 21(1) Maastricht Law Journal p 64, p. 68

132 For a definition of 'significant' see n 137 below

133 Credit institutions are institutions with authorisation or exemption to carry on the regulated activities of accepting regulated deposit, see Art 2(1) of Directive 2014/59, in accordance with Article 3.1(1) of Regulation (EU), No 575/2013 ("CRR"). This article defines a credit institution as "an undertaking the business of which is to take deposits or other repayable funds from the public and to grant credits for its own account".

134 Under Art 2(1) of Directive 2014/59 an investment institution is defined in Article 4.1(2) of Directive 2004/39/EC ("MiFID") as 'any legal person whose regular occupation or business is the provision of one or more investment services to third parties and/or performance of or more investment activities on a professional basis', and which is required to hold initial capital of EUR 730,000

135 This includes financial holding companies established in the EU (Art 1(1)(c) of the BRRD). These are parent undertakings with subsidiaries that are exclusively or mainly credit institutions, investment firms or investment firms (Art 2(1)(9) BRRD, Art 4(1)(20) CRR). Alternatively, it may be a subsidiary of a parent undertaking established in a third state (Art 2(1)(12) BRRD, Art 4(1)(30) CRR)

136 Recital 15 SRM Regulation

137 'Significant' under the SSM means credit institutions with a total asset value in excess of EUR 30 bn or exceeding 20 percent of the GDP of the Member State in which it is established, provided the total asset valued is less than EUR 5 bn or it has received a waiver allowing for supervision by the national regulator

138 See Art 7 of Regulation No 1024/2013; Art 4(1) SRM Regulation and Art 2(1) point 7 SSM Regulation

139 Art 2(b) SRM Regulation

140 Art 2(c) SRM Regulation; however, mixed-activity holdings, i.e. where a group entity is an insurance undertaking, are excluded from the scope

over central counterparties or investment firms that are not subsidiaries of a qualifying credit institution.

The SRM was established by a Regulation which came partially into effect on 1 January 2016. The SRM constitutes the second pillar of the Banking Union, which institutes an "unprecedented transfer of sovereignty from participating Member States to EU" institutions in order to safeguard the EU internal market. The other pillars are the SSM and the Deposit Guarantee Scheme. Importantly, the move towards a Banking Union signifies a change in regulatory approach from micro- to macro-prudential regulation. In other words, recognition of benefits for financial institutions is substituted for a more nuanced and balanced recognition of benefits for financial institutions in the context of risks to the EU financial system.

4.4.3.3 Interaction between BRRD and SRM

The interaction between the BRRD and SRM is somewhat convoluted. In principle, national resolution authorities are expected to execute the resolution scheme[141] prepared by the SRB.[142] For the execution, the national resolution authority refers to the national implementation of the BRRD. Consequently, there is a strong interdependence between the SRM Regulation and the national implementation of the BRRD. Although the text of the SRM Regulation closely mirrors that of the BRRD, the scheme may not be entirely executable for instance, due to implementation inaccuracies. The SRM Regulation requires that the SRB explicitly abide by the text of the BRRD.[143] Interestingly, Art 29(1) of the SRM Regulation requires national resolution authorities to have regard to the safeguards contained in the BRRD. In effect, national authorities may have to apply the BRRD *in lieu* of national law, thereby being placed in the awkward position of having to offend national law.

The implications for the construction of resolution provisions to be implemented at national level are the following. Recital 28 of the SRM Regulation provides relevant guidance. This recital states that the text of the Regulation shall override BRRD transposition. As a matter of European law, a recital may assist in bolstering the Court's interpretation of the articles of the Regulation,[144] support the interpretation of the relevant articles,[145] or even confirm the interpretation and intention of the European legislator.[146] In effect, it provides for a teleological interpretation of the Regulation. Although a conflicting article may override the recital, it will corroborate its interpretation. It may be inferred that the text of the SRM Regulation and implicitly also the resolution regime adopted by the SRB should override any deviating BRRD transposition, even if the BRRD were to allow for such deviation. If the national authority has discretion regarding the implementation or if there are no relevant national law provisions that conflict with the SRM Regulation, national law must be observed.

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141 Art 18(9) SRM Regulation
142 Art 29 SRM Regulation
143 Art 5(2) SRM Regulation
144 Case 38/81 (*Effer SpA v Kantner* Judgment of the Court (First Chamber) of 4 March 1982), p. 834
145 Case 197/80 (*Adorno v Commission* Judgment of 3 June 1981), p. 1485
146 Case 29/69 (*Stauder v Ulm*, Judgment of 12 November 1969), p. 425

4.5 Conclusion

The financial crisis has illustrated that financial institutions are different from other commercial entities.[147] This difference surfaced most noticeably as follows. First, the 2007 crisis experience has shown that it is likely that failed financial institutions cannot continue to trade effectively. Consequently, they are more likely to be subject to a system of liquidation than to one of administration, provided it can be ensured that no ramifications for financial stability will ensue.[148] Second, therefore, resolution regimes primarily aim, in contrast to insolvency regimes, to separate operating liabilities from financial liabilities.[149] The above suggests that the regime for managing distressed financial institutions needs to be addressed accordingly.[150] A unique and inherent feature of financial institutions is that distress can threaten financial stability.[151] As a consequence, global consensus formed on the need to establish crisis management regimes pertinent to financial institutions.

The argument of systemic risk should be strictly limited to financial institutions and its counterparties since financial interconnection is required for the transmission of distress. The pricing of derivatives is complex and volatile. As a consequence, the exposure between parties is continuously changing such that, due to market movements, a net obligation may reverse into a net claim. Such volatile exposure necessitates a mechanism facilitating its management and requires "[t]he use of flexible and liquid collateral".[152] On the other hand, it has been suggested that the ability to close out has replaced financial instruments with a more extended tenor that are considered safer.[153]

However, this systemic risk does not emanate from the presence of close-out netting. Thus, the adverse effects commonly ascribed to netting can be found elsewhere. Examples of reasons are the number of standardised arrangements facilitating herding behaviour, the pivotal role of financial contracts for financial institutions, and, to some extent, complexity. Systemic risk results from complex and inextricably linked operations of financial institutions. Constraining the ability to net would therefore negate the benefits while failing to address the more obvious issues – and would thus be counterproductive.

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147 See Franklin Allen, Elena Carletti and Xian Gu, 'The roles of banks in financial systems' in Allen Berger, Philip Molyneux and John Wilson (eds) *The Oxford Handbook of Banking* (2nd edn, Oxford University Press 2014) p. 27 and Richard Herrring and Jacopa Carmassi, 'Complexity and systemic risk: What's changed since the crisis?' in Allen Berger, Philip Molyneux and John Wilson (eds) *The Oxford Handbook of Banking* (2nd edn, Oxford University Press 2014) p. 77

148 See Bank of England, HM Treasury and the Financial Services Authority, *Financial stability and depositor protection: further consultation* (Cm 7436, 2018) p. 137

149 Figure 2 lists some financial liabilities, whereas Figure 3 shows a number of operating liabilities

150 For background see Eva Hüpkes, 'Insolvency – why a special regime for banks?' (2003) 3 IMF Current Developments in Monetary and Financial Law p. 13

151 This assertion was certainly true during the financial crisis and in its direct aftermath. More recently, however, attention has diverted to financial market infrastructures such as CCPs. See Financial Stability Board, *Guidance on Central Counterparty Resolution and Resolution Planning. Consultative Document* (2017)

152 Louise Gullifer, 'What should we do about financial collateral' (2012) 65 Current Legal Problems p. 377, p. 382

153 Viral Acharya and Sabri Öncü, 'A proposal for the resolution of systemically important assets and liabilities: The case of the repo market' (2013) 9 International Central Banking p. 291, p. 307

Chapter 5
Bank insolvency and resolution

The previous chapters have demonstrated that the financial crisis has led to profound changes of the regulatory notions applicable to large and complex financial institutions. In fact, there has been a paradigm change at a global level. England, however, implemented its own responses during the financial crisis. Whereas the initial regimes contained sunset clauses which were extended, a permanent regime was established under the Banking Act 2009. [1] The Act is a pragmatic response to the financial crisis of 2007 and is far from a black-letter law.[2] Initially being a purely English initiative, it was adapted to comply with the BRRD.[3] The English response to the financial crisis was in many respects exemplary. Under the Banking (Special Provisions) Act 2008, the Treasury was empowered to issue transfer orders, which had the effect of varying terms of the debt instrument and extinguishing share options. This right migrated into the Banking Act 2009. Surprisingly, these measures have been praised for constituting legal innovations under the BRRD. However, the BRRD resolution measures did not need to be transposed as they were already largely contained in the Banking Act 2009. Moreover, the modification of the terms of debt instruments under the bail-in tool was also already provided for by the Banking Act 2009 (and its predecessor) in connection with transfers. Thus, bail-in to the extent that it applies to financial institutions is not a foreign element either. It constitutes a novelty to the extent that it allows the allocation of losses before the commencement of insolvency. It shall be noted that bail-in under the BRRD does not require application of other resolution measures. However, it is doubtful that mere invocation of the bail-in tool is sufficient to stabilise a distressed financial institution. Thus, the preferred measure is and remains transfer. This measure was supplemented by a suspension restricting the rights of trade creditors, including counterparties to financial contracts.

The fact the the Banking Act 2009 predates the BRRD explains the differences in appearance as well as more substantial differences. In contrast to the BRRD, the English framework also contains modified insolvency law regimes that can be applied to financial institutions. This approach offers significant benefits, as will be seen in this chapter. The resolution of a financial institution requires a seamless transition from heightened supervision, to recovery or resolution, and if applicable, winding-up proceedings. An important lesson learnt from the 2007 financial crisis is that financial institutions need not necessarily be rescued in their entirety to safeguard financial stability. Migration of critical parts to a third party should suffice, as we will see below. The residual institution should be subsequently subject to insolvency proceedings. However, full transfer of the critical parts is not

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1 The Banking Act 2009 received Royal Assent on 12 February 2009 and established a permanent resolution regime in England and Wales. The Banking Act has been amended various times, such as by the Financial Services (Banking Reform) Act 2013 to take the recommendations of the Vickers Report into account, and by the Bank Recovery and Resolution Order 2014, to adjust the existing regime to the BRRD provisions

2 Mark Hsiao, 'Legitimised interference with private properties - Banking Act 2009' (2010) 25(5) Journal of International Banking Law and Regulation p. 227, p. 229

3 The Banking Act 2009 covered the entire United Kingdom, with the exceptions of sections 253 and 254, which apply only in Scotland

always possible. To apply insolvency proceedings to a residual institution, the proceedings objectives must be realligned with that of resolution – in order to protect financial stability. This chapter discusses the English financial institution insolvency and resolution regime.

The first section examines the first part of the Banking Act 2009, empowering the Bank of England ("BoE") to adopt resolution measures against financial institutions that are failing or are likely to fail their threshold conditions,[4] provided that there is no suitable alternative.[5] This section argues that such measures may impair the ability to exercise rights under the credit risk mitigation techniques or considerably restrict their effect. In contrast to the international standards, the European implementation entails a wider scope of the liabilities, including financial contracts. However, this requires the use of ancillary powers.

The second section analyses the ancillary powers that facilitate the application of resolution measures. A repeated criticism is that close-out netting represents an obstacle to the recovery and rehabilitation of distressed debtors as well as to the recovery and resolution of financial institutions. Termination rights must therefore be stayed, which provides integral contractual stability. The third part moreover analyses the ancillary measures to apply resolution measures against financial contracts. Unlike debt contracts, financial contracts comprise bilateral obligations. Therefore, to apply resolution measures, it is essential to exercise close-out netting. Third-state aspects are also discussed in this subsection, which is important seeing that if the master agreement is governed by the laws of a third state, counterparties located in that third state may attempt to challenge Banking Act 2009 measures. Thus, for resolution measures to be implemented effectively, these contracts too must fall within the jurisdiction of the BoE.

The third section considers the issues that arise from transactions where non-defaulting party is situated in a third state and the contract is by a non-EEA law. Since the application of the resolution measures requires a certain degree of coersion in relation to the non-defaulting counterparty, procedural problems and challenges were expected. To facilitate the application of resolution measures, the legislator had to develop additional requirements.

The fourth section explores the English insolvency and administration proceedings that can be applied to distressed financial institutions. These regimes are encompassed in the second and third part of the Banking Act 2009, respectively. They must accommodate the differences in undertakings and services, and in structures. While all sorts of financial institutions can enter into financial contracts, investment firms and investment banks have the most significant exposures and provide the essential infrastructure. Therefore, this section discusses the regime's application to credit institutons and investment firms in detail.

The last section concludes this chapter, stressing the need to adapt insolvency laws to financial institutions. The BRRD itself does not provide for sufficient remedial measures. Since the transferee

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4 It is applicable to financial institutions that, pursuant to the Financial Services Markets Act 2000, are permitted to accept deposits, and building societies which are failing or likely to fail. See Sch 6 to the Financial Services and Markets Act 2000. The threshold conditions are stipulated in section 41 of the FSMA 2000.

5 This means that it should not be reasonably likely that any other action will be taken to avert failure

must continue supporting the transferor, and the objectives of resolution and insolvency need to be aligned. It is argued, however, that the European and, as a consequence, the English regime have transcended the internationally agreed scope of resolution. The application of resolution measures to financial contracts carries significant obstacles. Although presumably sufficient ancillary powers and safeguards have been introduced, significant challenges remain with regard to third states, which have to be resolved by the financial sector.

5.1 Stabilisation options and powers and resolution measures

When introducing Part 1 of the Banking Act 2009, Alistair Darling[6] stated that the permanent special resolution regime aims to accelerate the transfer of a bank.[7] While reflecting on the approaches to managing distress, he claimed that, although in most cases early intervention and voluntary action will suffice, the regime removes controls and powers of directors, shareholders and creditors.[8] In case the financial institution or its group entities are likely to infringe their licensing requirements, HM Treasury or the BoE may exercise certain powers. The special resolution regime consists of the following:

The five stabilisation options (applicable to a distressed financial institution) set out in section 1(3) of the Banking Act are:

a. Transfer to a private sector purchaser;
b. Transfer to a bridge bank;
c. Transfer to an asset management vehicle;
d. Transfer to temporary public ownership; and
e. Conversion of certain liabilities into equity or certificates of ownership, or write-down or modification of certain liabilities, i.e. bail-in.

The stabilisation options are effected through the "stabilisation powers". The stabilisation powers are (i) share transfer (involving a transfer instrument within the meaning of section 15 and the transfer order under section 16), (ii) resolution instruments (including bail-in under section 12A), (iii) property transfer (including property transfer under section 33), and (iv) third-state instruments (including instruments made under sections 89H and 89I recognising equivalent measures exercised by third-state authorities).

Before the measures of the Banking Act 2009 can be applied against the following types of financial institution: Financial institutions which are authorised to accept FCSC-protected deposits under the Financial Services and Markets Act 2000, building societies (though subject to specific modifications), clearing houses authorised under the European Market Infrastructure Regulation,[9] and banking group companies (specified undertakings that are in the same category as banks, investment firms or CCPs) fall within the scope of the Banking Act 2009. However, the Act does not

6 The former Chancellor of the Exchequer
7 Hansard, HC Vol.480, col.700 (October 14, 2008)
8 Hansard, HC Vol.480, col.702 (October 14, 2008)
9 Regulation No 648/2012 ("EMIR")

apply to credit unions and investment firms (with an initial capital requirement of less than EUR 730,000 (or its equivalent). [10]

the BoE must be satisfied that (i) the institution is failing or is likely to fail, (ii) exercise of the special recovery and resolution powers is required, is within the public interest and advances the objectives set out in section 4 of the Banking Act 2009, and (iii) the resolution objective cannot be met via an ordinary insolvency procedure. For this purpose, it must be first considered that no alternative private solutions that could avert further erosion are feasible with regard to the timing and other relevant circumstances. The financial institution is failing or is likely to fail when amongst other the requirements for the regulatory licence is threatened.[11]

The administration and insolvency proceedings under the Banking Act 2009 can be applied against the residual entity after application of one of the aforementioned stabilisation options).The above options do not substitute traditional administration, winding-up or liquidation proceedings. On the contrary, for financial institutions that do not satisfy the resolution objectives, the traditional regime will be the only choice. Hence, resolution does not constitute an alternative to insolvency. Once the five objectives under section 4 of the Banking Act are met, ordinary insolvency law can be applied. Conversely, if these five objectives are not met, application of resolution will be necessarily disproportionate and arbitrary, thereby undermining market certainty. Unlike the Banking Act 2009, the BRRD does not contain specialised insolvency regimes whereby the application of resolution measures can be kept to a minimum. Hence, systemically relevant parts can be separated and continued as going concern while the residual institution that will be subject to the special insolvency regime can support the transferred parts while being wound down or liquidated.

5.1.1 Transfer options

This measure allows transferring certain assets or part of the business from a distressed institution to a transferee. This transferee can continue operating the assets or part of the business as going concern. Thereby, the value that would otherwise be lost in dissolution is maintained and essential market functions can be continued. Thus, disruptions to the financial markets, creditors and even depositors are contained. Unsurprisingly, in relation to financial institutions and companies, this measure has formed part of the liquidator's powers for a long time. Its importance was reaffirmed when the transfer measure in the Financial Market Act 2000 was explicitly mirrored in the Banking Act 2008, the predecessor of the Banking Act 2009, as will be discussed below.

5.1.1.1 Background

Transfer of the business of insolvent companies has formed part of the measures available to administrators and liquidators for a long time.[12] Transfer was also used to manage distressed

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10 See Anthony Pavlovich, 'Banking group companies: which entities are caught by the Special Resolution Regime?' (2015) Journal of International Banking and Financial Law p. 97

11 The PRA can revoke the bank licence if the financial institution fails to meet the requirements under Part 4A of the FSMA 2000 to carry on regulated activities

12 Section 110 of the Insolvency Act 1986.

financial institutions during the financial crisis.[13] Part VII of the Financial Services and Markets Act 2000 contains various transfer schemes.[14] These allow for the transfer of business, including deposits, provided certain preconditions are met.[15] Unlike in the case of other regulated entities, such as insurance companies, application of this scheme to financial institutions is optional.[16] This transfer is effected under a court order pursuant to section 112 of the Financial Services and Markets Act 2000. Under this section, all contractual rights that result in termination or modification are expressly restricted until the court lifts the restriction.[17] However, the restriction may be continued in the case of certain contractual rights not specifically permitted by the court order. The policy rationale is that the court is empowered to do what it deems "necessary to secure that the scheme is fully and effectively carried out". Close-out netting can be applied against the residual entity.

The above suggests that under this kind of court order, the enforceability of credit risk mitigation techniques can be restricted. A non-defaulting party's enforcement rights are suspended until the order is lifted. In the context of financial contracts, it should be noted that the transfer or merger constitutes a termination event. However, if such events are the result of the operation of law, termination rights cannot be invoked. Such events include the initiation of a transfer or merger and other related events. This does not suggest that the court has the power to split up close-out netting or collateral arrangements. Although not explicitly mentioned in the relevant section, it is a principle of English law that credit risk mitigation techniques shall take effect in accordance with their contractual terms.[18] In case a court order envisages a split-up of arrangements, it must provide a host of new principles to address the wind-up or liquidation, which may contravene the intention of Parliament and will consequently be *ultra vires.*

Thus, though not essential, providing express safeguards is desirable in order to mitigate associated uncertainty. As will be seen below, this will be particularly true if such a regime is to be introduced in other jurisdictions, as part of the BRRD.

5.1.1.2 Transfer under the Banking Act 2009

The Banking Act 2009 envisaged the transfer of a financial institution or its systemic relevant parts. Therefore, to comply with the BRRD, the asset separation tool had to be added.[19] Given the history of transfers, it is not surprising that the transfer option is listed as the first stabilisation option. It

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13 For instance, the Heritable Bank plc Transfer of Certain Rights and Liabilities Order 2008, Kaupthing Singer & Friedlander Limited Transfer of Certain Rights and Liabilities Order 2008, Transfer of Rights and Liabilities to ING Order 2008, Northern Rock plc Transfer Order 2008, Bradford & Bingley plc Transfer of Securities and Property etc. Order 2008 and section 4.1.1

14 Part VII applies to all financial institutions except building societies

15 See section 106 of the Financial Services and Markets Act 2000

16 See para 12 of Sch.1 to the Financial Services (Banking Reform) Act 2013

17 Section 112(1)(c) and (d) of the Financial Services and Markets Act 2000; The Explanatory Notes to the Financial Services and Markets Act 2000 (Amendments to Part 7) Regulations 2008/1468 stipulate: "Subsections (2A) and (2B) make clear for the avoidance of doubt that the power of the court to make an order under section 112 is to be taken as always having included the power to transfer, for example, contracts which include provisions prohibiting their transfer or contracts in relation to which there is a query as to their transferability in the absence of consent of a counterparty or contracts where there is a contravention, liability or interference with a right or interest which arises as a result of the transfer."

18 See section 2.4

19 Section 12ZA of the Banking Act 2009 inserted by Art 19 of the Bank Recovery and Resolution Order

resembles the sale of business tool as it allows the entire or partial transfer of a financial institution.[20] However, the differences are the scope of the option and the instruments effecting it.

(a) Transfer instruments

The BoE effects (i) the transfer of shares through a "share transfer instrument"[21] or (ii) the transfer of assets, rights, liabilities through a "property transfer instrument"[22] (as discussed below). It arranges stabilisation by transfer. A distressed financial institution cannot affect the purchase by a third party.[23] The reason is that the takeover necessitates regulatory approval and shareholder consent which is too onerous as to constitute a practical solution. Hence, the BoE's share transfer order overrides these legal obstacles.[24] Transfer instruments include incidental, consequential and transitional provisions, which can override contractual rights.[25] A partial transfer order is not applicable to "protected rights and liabilities" (as will be further explored below) in order to mitigate the risk that credit risk mitigation arrangements might be separated in the process.[26]

Share transfer power

The term "share transfer" is a misnomer since the instrument also covers debt instruments and other equity tools such as warrants.[27] Similarly to the power under section 112 of the Financial Markets Service Act 2000, this "security" transfer instrument provides ancillary powers effecting the transfer. It includes, again, the right to restrict the enforcement of rights and credit risk mitigation arrangements. However, after the restriction has been lifted, the parties can invoke their rights as long as the event of default persists; however, if the default is cured, any enforcement as described above will be overridden.

Property and partial property transfer powers

The property transfer power permits transferring all the property, assets and liabilities of a distressed financial institution. The partial property transfer power allows, in contrast to property transfer power, that only part of the property is transferred. After application of this power, the initially distressed financial institution becomes a residual institution[28] that will be subject to insolvency or administration proceedings. Unsurprisingly, the latter power gave rise to concerns that close-out netting and collateral arrangements might be split up. Accordingly, the Banking Act 2009 (Restriction of Partial Property Transfer) Order 2009 was introduced.[29] This order prohibits the transfer of some but not all

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20 Section 11(1) of the Banking Act 2009

21 Section 15 of the Banking Act 2009

22 Section 33 of the Banking Act 2009. If the property transfer instrument is only applied to part of a distressed financial institution, the measure is referred to as a partial property transfer

23 Although the takeover of HBOS by Lloyds TSB was supported by the Bank of, the Banking Act 2009 restricts, in principle, private takeovers if one bank is distressed, see Dalvinder Singh, 'The UK Banking Act 2009, pre-insolvency and early intervention: policy and practice' (2011)1 Journal of Business Law p. 20, p. 30

24 Sections 17 and 34 of the Banking Act 2009

25 Sections 23 and 40 of the Banking Act 2009

26 Art 3 of the Banking Act 2009 (Restriction of Partial Property Transfers) Order 2009

27 Section 14 of the Banking Act 2009

28 A "residual institution" is a financial institution or any part of it whose business, property, assets and/or liabilities have not been transferred

29 The initially proposed Order was widely criticised by market participants, since its scope was too narrow and would not cover various genuine agreements. Thus, if certain transactions were not within the scope of the Order, the netting arrangement could be rendered void. It follows the adage 'one bad apple spoils

of the "protected rights and liabilities" under a "netting arrangement" or "set-off arrangement". This protection is now stipulated in section 48 of the Banking Act 2009. In the explanatory memorandum, the Government states:

> This power enables certain private law rights to be protected when the property transfer powers are exercised to effect a partial transfer. …
>
> Subsection (1) broadly defines the certain interests ('protected interests') for which the power may provide protection. This provision reflects the extremely broad range of relevant interests which exist in this field. The interests which the exercise of the power is intended to cover may include, for example, security interests and set-off and netting arrangements.

Since the master agreements documenting the financial contracts constitute arrangements within the meaning of section 48(1) of the Banking Act 2009, the BoE should, in principle, not be able to challenge them, to the extent that they are genuine and are not devices with the sole purpose of complicating the transfer.

The order stipulates that any partial property transfer made in contravention to the above, the close-out netting and enforcement rights should be valid and enforceable.[30] Any transfer executed while the netting or set-off rights were not exercised, for instance, because the order was unbeknownst to the non-defaulting party, must be reversed or otherwise remedied.[31] Although the meaning of "otherwise remedied" is unclear, it presumably implies that the non-defaulting may calculate the close-out amount and the BoE will be liable for the net obligation.

(b) Transferees

When applying the abovementioned transfer orders, the BoE needs to appoint a qualifying transferee capable of assuming the assets and liabilities of the distressed financial institution. In this respect, the following institutions are conceivable:

Private sector purchaser

The sale of business tool empowers resolution authorities to transfer all shares or all or any assets, rights or liabilities of an institution under resolution to a private purchaser. Ostensibly, a share transfer is not of concern to a non-defaulting counterparty given that that counterparty remains the same entity. However, if the resolution authority orders the transfer of assets, rights or liabilities, financial contracts may be directly or indirectly affected in particular if it results in a separation of the netting sets and the related collateral. Provided that the resolution authority observes the netting, title transfer or security arrangement, the non-defaulting counterparty will be exposed to a new institution. A transfer will presumably be to a financial institution which (i) has a positive value, (ii) has

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the barrel'. Hence, genuine and economically valuable transactions could become unenforceable due to potential loss of hedges. Lord Myners submitted that "[i]f changes to the order are necessary and compatible with the authorities' flexibility, the Government will make such changes", see Official Record, 16 March 2009: Column GC2 to GC3. Subsequently, the Banking Liaison Panel suggested that the "full range of transaction types that could be covered by the definition of 'relevant financial instruments'" should be accorded the protection of the order, see Rodrigo Olivares-Caminal, John Douglas, Randall Guynn, Alan Kornberg, Sarah Paterson, Dalvinder Singh, Hilary Stonefrost, *Debt Restructuring* (Oxford University Press 2011) p. 277 and Banking Liaison Panel, Subgroup on the Banking Act 2009 (Restriction of Partial Property Transfers) Order 2009

30 Art 11(1) and (2) of the Banking Act 2009 (Restriction of Partial Property Transfer) Order 2009

31 Art 12 of the Banking Act 2009 (Restriction of Partial Property Transfer) Order 2009

a bank licence or similar and/or (iii) meets the necessary regulatory requirements to continue the operation of the transferred parts. In contrast to the institution subject to resolution, the new counterparty may be expected to be better capitalised and more likely to honour impending obligations. However, certain arrangements may not be transferred under the sale of business tool and will thus remain at the residual institution. A successful transfer may cure the default, thereby restricting the ability to terminate unless the event of default is ongoing and unrelated to the resolution measure itself. However, if the arrangement remains at the residual institution, close-out netting rights may be exercised.

This resolution option is the preferred choice. In particular, it is most promising alternative in light of the objectives of the special resolution regime according to the Financial Services Authority, BoE and HM Treasury's joint statement for the benefit of the Chancellor of the Exchequer:[32]

> A private sector solution is likely to be the resolution outcome that best meets the SRR objectives. Such an outcome has the potential to maintain financial stability, provide continuity of banking services to depositors, achieve desirable outcomes for creditors and counterparties and protect public funds.

In contrast to other options and transferees, it does not encumber public assets. However, on balance, public support will be inevitable, because also in case of private sector purchase the transferee may require government guarantees to cover distressed portfolios that were acquired hastily without the otherwise necessary due diligence. Ostensibly, portfolios of derivatives, or including derivative components, are most likely to represent potential risks due to the contingent obligations. Thus, though profitable, it is unlikely that they will form part of the transfer if not strictly required to continue systemically important functions of the transferor. It is impossible to anticipate with certainty the potential treatment as market requirements may necessitate the transfer and, implicitly, also public guarantees.

Bridge institution

Like with the sale of business tool, under the bridge institution tool, shares, or all or any assets, rights or liabilities may be transferred. In contrast to the above, the transferee is a public legal entity which has been established solely for the purpose of the transfer and is managed by the BoE.[33] Hence, a bridge institution can be substituted for the institution subject to resolution under the same powers as in the case of the sale of business tool. A bridge institution has the aim of selling the assets or business; the transfer is intermediate in order to preserve market stability.[34] It implies that after this intermediate period the financial contracts must either be transferred to a new institution, or morph into an asset management vehicle (as explained below) or become subject to insolvency proceedings.

In contrast to the latter tool, however, the bridge institution tool has peculiar characteristics. Unlike a private purchaser, a bridge institution is expected to operate only as a temporary measure,

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32 Financial Services Authority, Bank of England and HM Treasury, Financial stability and depositor protection: special resolution regime (Cm 7459; 2008) para 3.15

33 Section 12 of the Banking Act 2009

34 Section 12(A) of the Banking Act 2009

presumably for a period not exceeding two years. [35] It is, however, impossible to predict the ability to recover or find a private solution, given the intricacies of and correlation with economic and financial factors outside the control of the BoE. Since it is a newly established entity, a bridge institution will have no positions or operations other than those transferred from the institution subject to resolution. Consequently, although the bridge institution will have a bank licence, its capital position is likely to be inferior to that of a private purchaser. Due to the novelty, its access to the market and the market participants general perception of it may be tainted. That concern is reinforced by the fact that it received assets and liabilities from a distressed institution, which begs to question their quality. As a consequence, its responsiveness to market forces may differ considerably from that of a private purchaser.

Overall, it constitutes a hybrid approach. On the one hand, it is an intermediary solution between the distressed institution and the other transferees. On the other hand, it combines both private and public sector involvement, which may also evolve.[36] Thus, at the first stages following the bridge bank's establishment, the BoE will play a decisive role in setting its objectives and direction. This does not suggest that it will be involved in its daily operations. However, it will determine the anticipated fate of the bridge bank's shareholders and creditors – keeping in mind the prior application of the bail-in option. The daily operations will be performed by the management of the institution under resolution or by an external management board appointed by the BoE. It should be recalled that the ultimate goal is the return of the institution to the market; hence, towards the end of the BoE's participation as a shareholder of the bridge bank, its involvement will diminish.

Asset management company

Like the abovementioned resolution tools, the asset separation tool provides for the power to transfer assets, rights or liabilities from an institution subject to resolution or a bridge institution. It differs to the extent that the transferee is one or more public institutions with the sole purpose of wind up assets and liabilities. These vehicles shall seek to maximise the value of the assets received while minimising liabilities and ramifications for the financial market.[37] Measures that can be employed by the asset management vehicle include an orderly sale or wind up. Unlike in the case of bridge institutions or private purchasers, the continuation of the business is not an objective. Hence, an asset management vehicle is unsuitable to operate systemically important parts of distressed financial institutions as going concern. Loan portfolios or sizeable loans are usually linked to financial derivatives envisaged as hedges, for instance, fluctuations in interest rates or currencies. It is conceivable that a financial derivative or a close-out netting arrangement may be transferred to an asset management vehicle in conjunction with a distressed loan. Consequently, it is necessary that the performance of the obligations under the master agreement will be performed. If it is not a public vehicle benefiting from a guarantee, it shall be constituted as a normal private law vehicle.

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35 Art 41(5) of the BRRD

36 Rodrigo Olivares-Caminal, John Douglas, Randall Guynn, Alan Kornberg, Sarah Paterson, Dalvinder Singh, Hilary Stonefrost, *Debt Restructuring* (Oxford University Press 2011) p. 270

37 Section 12ZA(4) of the Banking Act 2009

Temporary public ownership

An example is Bradford and Bingley, which was only partially placed into temporary public ownership.[38] A public transferee is only considered as a last resort, due to its propensity to encumber public assets. Unlike in the case of the other transferees, when in temporary public ownership, the institution may be expected not to have to obtain a bank licence. From this, it can be inferred that it will not be subject to the same management and risk governance principles. Stakeholders will belief that the institution's obligations will be met as there is an implicit or even express state guarantee.

5.1.1.3 Application to financial contracts

Ostensibly, parties that remain in the residual institution receive a different treatment than those subject to the transfer. Accordingly, the HM Treasury must consider "the desirability of ensuring that if a residual bank enters insolvency after transfer, pre-transfer creditors do not receive less favourable treatment than they would have received had it entered insolvency immediately before transfer".[39] Moreover, by way of compensation order, the HM Treasury has the ability to compensate those creditors that remain in the institution.[40] Such compensation shall restitute affected creditors. To assess the damage, the following counterfactual is simulated which serves as threshold for the losses that would be incurred if resolution was not available. It simulates the effects of an insolvency proceeding or restructuring measure. It permits determining whether creditors in the residual institution experience worse treatment than those who have been transferred.

5.1.2 Bail-in option

The original policy motivation of bail-in is to create a regime of "self-insurance". It substitutes the recourse to external funds with internal funds.[41] The concept hinges on the idea that those assuming credit risk should thus also assume the risk that their claim will be reduced in order to rescue the investee. In effect, owners - both shareholders and creditors - must contribute funds to allow the financial institution to continue operating as going concern.[42] The FSB never suggested that all creditors, including trade creditors, should be affected. It follows from the inside that trade creditors are in a worse position to monitor the credit standing of the counterparty. Trade creditors provide integral services – not merely capital yielding return due to the assumption of credit risk. An argument often advanced in academic literature is that bail-in promotes market discipline by eradicating implicit government guarantees for investors. This argument is often conflated with the benefits of augmented monitoring, due to the increased risk of loss. However, those arguments are not applicable to trade creditors. Extending the scope to those involved in daily and fundamental

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38 Chris Bates, Kate Gibbons, Rosalind Gray, Julia Machin, Habib Motani and Tim Plews, 'Bradford and Bingley plc: Break up under the Banking (Special Provisions) Act 2008' (2008) 11(9) *Financial Regulation International p. 1*

39 Section 60(2) of the Banking Act 2009, see Phoebus Athanassiou, 'Valuation in resolution and the "no-creditor-worse-off principle"' (2014) Journal of International Banking and Financial Law p. 16

40 Section 60 of the Banking Act 2009

41 Nicola Kemp, 'Bail-in powers: from simple concept to complex reality' (2011) Journal of International Banking and Financial Law p. 625

42 In practice, the funds in bail-outs were used to ensure the repayment of creditors. It led to a distortion of market practice. Paul Weismann, 'Banking crisis and banks in crisis: from state aid to bank resolution' (2016) 37(9) European Competition Law Review p. 384

operations goes beyond the objective of bail-in and is inconsistent with the benefits attributed to bail-in. However, it increases transaction costs and affects the terms of trading.

5.1.2.1 Background

During the financial crisis of 2007, it was evident that the absorption of losses constituted a significant impediment to crisis management. It follows form the neccessity to obtain creditors' consent for the allocation of losses to creditors[43] or the initiation of insolvency proceedings – both of which means that were considered inappropriate, not least due to inevitable loss of confidence. Consequently, in 2011 the Independent Commission on Banking proposed the application of bail-in to facilitate the absorption of losses, thereby improving the prospect of recovery of distressed financial institutions. Interestingly, the resulting Vickers Report proposed to divide the bail-in measure into two separate powers depending on the type of obligations. Whilst the first power may be applied to debt instruments such as bonds, the latter can be applied against all liabilities, viz. obligations of trade creditors or contracts that may form a payment obligation such as indemnities.

The Independent Commission on Banking ("ICB") under Sir John Vickers served as a forum for this discussion, recommending, in 2011, loss of absorption via bail-in.[44] In particular, the ICB recommended introducing a primary and a secondary bail-in power. The former allows attributing losses to equity and debt instruments before any other non-capital and non-subordinated liabilities are affected, whereas the latter allows, if required, imposing losses on all other unsecured liabilities. Underpinned by the supportive argumentation of the FSB KA[45] and the Parliamentary Commission on Banking Standards, the Parliament passed the Financial Services (Banking Reform) Act 2013 that conferred bail-in power on the BoE. It thereby pre-empted the European bail-in regime. However, since concerns were raised that the regime might have to be adapted to the European regime in the short run, it was determined that the effective date should be attuned to the introduction date of the European bail-in regime.[46]

This measure was a primary objective of the post-crisis regulatory agenda.[47] The bail-in tool empowers resolution authorities to cancel, write down or write off liabilities or convert them into equity capital. It makes it possible to apportion losses to creditors before and without the inception of formal insolvency proceedings. This background explains why bail-in was perceived as a "bedrock" of the new resolution regime. A side effect of the ability to reduce liabilities outside formal insolvency is that the implicit state guarantee is excluded from the pricing of liabilities. The presumption that it is impossible to apply ordinary insolvency procedures is based on its impracticality vis-à-vis financial institutions. As a consequence, certain financial institutions enjoyed

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43 See the discussion on voluntary measures in section 2.4

44 Independent Commission on Banking*, Final Report Recommendations* (2011)

45 Financial Stability Board, Key Attributes of Effective Resolution Regimes for Financial Institutions (2011 as amended in 2014)

46 HM Treasury, Transposition of the Bank Recovery and Resolution Directive (July 2014) para 11.6

47 Bail-in has been advocated as a promising solution to end the too-big-to fail problem, see [TBTF literature] Bail-in, however, clearly has its limitations, see Simon Gleeson and Randall Gyunn, *Bank Resolution and Crisis Management: Law and Practice* (Oxford University Press 2016) para 10.9; Abigail Boyd, 'Bail-ins — Just Another Self-Fulfilling Prophecy?' (2012) 27 Banking & Finance Law Review p. 599 and Emilios Avgouleas and Charles Goodhart; 'Critical Reflections on Bank Bail-ins' (2015) 1(1) Journal of Financial Regulation p. 3

an implicit state guarantee. Hence, bondholders were uninterested in selecting and monitoring a financial institution if it could be deemed to be vital for financial markets and its failure would have catastrophic consequences -moslty large and interconnected financial institutions.

Bail-in was also expected to militate against the too-big-to-fail concept since it allows *in situ* recapitalisation, i.e. without recourse to public and extraordinary funds. However, subjecting the trading business to bail-in is inconsistent. Although financial contracts form a sizeable obligation, the bail-in of financial contracts poses significant challenges unlike funding instruments. A characterising difference is the fluctuating value of financial contracts and contingent obligations, and consequently of any amount which can be bailed in. The ramifications that may ensue for other market participants are prohibitive. Resolution measures themselves can significantly affect the value. Debt instruments are not liable to strong fluctuations. Whilst their value is affected to some extent by the trading,[48] the value will ultimately depend on terms of the debt instrument. In contrast, the value of financial contracts also depends, amongst others, on the perceived risk of each party, leveraged changes of reference values and market rates.

Cognisant that at European level a similar regime was being developed, the English legislator delayed the introduction of bail-in. However, it included a "legislative reminder … to do something about the mechanism of bailing in derivatives when there [is] greater clarity from the BRRD about how derivatives were best to be treated", as suitably formulated by Connelly.[49] Otherwise, the English bail-in regime might be incompatible with the BRRD regime, which would require adaptation of the English regime. The BRRD was published in May 2014, initiating the development of the English domestic regime. The Directive addressed some of the risks set out in the Vickers Report, in particular as regards conflicting provisions in EU legislation, such as in the Reorganisation and Winding up of Credit Institutions Directive and the Financial Collateral Directive.[50]

The bail-in tool in the BRRD was implemented by virtue of section 17 of the Financial Services (Banking Reform) Act 2013 ("Banking Reform Act") in conjunction with Schedule 2 of that Act amending the Banking Act 2009. The amendments introduce a stabilisation tool called the bail-in option by inserting a new section 12A in the Banking Act 2009. This section empowers the BoE to develop one or more resolution instruments which may contain provisions or proposals contemplated by section 12A, subsections 3 to 6. The special bail-in provision also provides, for instance, that the financial instruments may be transferred to a bail-in administrator or another person.

5.1.2.2 Scope

The term "liability" covers virtually every kind of obligation that arises from the business of the financial institution. However, it may be inferred that it can only encompass liabilities which can

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48 The fluctuations in market price depend mostly on the ability of the issuer to honour its obligations, which takes into consideration the validity of the issuer's disclosure and any information on impending distress of some form

49 Stephen Connelly, 'The Implementation of the EU Bank Recovery and Resolution Directive's Derivative Bail-In Powers in the UK' in JH Binder and D Singh (eds), Bank Resolution: The European Regime (Oxford University Press 2016)

50 See sections 3.2 to 3.4

technically be bailed in and are not liable to cause or contribute to systemic risk. For instance, it is conceivable that a catering contract which obliges the financial institution to make a payment could fall within the scope of the bail-in tool. However, technical feasibility in this respect is limited. Thus, liabilities arising from frequent or substantial transactions of the financial institution are more likely to fall within the scope of the tool. It may be inferred that security financing and derivative transactions can be subject to bail-in. The BRRD does not specify what kind of arrangements come within its scope. Art 49 of the BRRD expressly provides for the application of bail-in to derivatives, due to the additional requirements to enforce close-out netting arrangements prior to bail-in.

(a) Fully secured liabilities

Financial contracts that are "fully secured liabilities" or "fully collaterised on a continuous basis" are exempted.[51] The PRA Rulebook prescribes the preconditions. First, the financial contract must be fully collaterised at the time it was created. In case of financial derivatives, this means that the initial margin or independent amount and variation margin need to cover the whole exposure. Similarly, in case of SFTs, the securities amount must be commensurate with the cash amount.

Second, the relevant party must maintain the liability fully collateralised on a continuous basis from the point of creation. At present, there is no definition of what constitutes "continuous". In practice, adjustment of the independent amount and variation margin is periodic. "Continuous" in its mathematical sense is practically impossible. Due to this periodic adjustment of collateral, a shortfall is inevitable as a result of the rapid market movements and levered effects. The PRA Rulebook provides that the contractual terms must oblige maintenance on a continuous basis, as specified in Delegated Regulation 2016/2251 ("Risk Mitigation RTS"). Alttough it applies only to derivatives, it would be logical to apply by analogy to other financial contracts.

Thus, the term "continuous" should be construed to apply only to the part of the financial contract that is fully collaterised on the dates relevant for the resolution authority. These dates include the dates when the financial position of the distressed financial institution is ascertained, the resolution strategy is developed, and the resolution strategy is executed.

(b) Exceptional circumstances

"Exceptional circumstances" may allow the resolution authority to exercise some discretion and to exclude certain liabilities. This right is contained in section 48B(10) of the Banking Act 2009 and may be based on the following grounds. First, it is impossible to apply bail-in within a reasonable time. Second, exclusion is a necessary and proportionate condition precedent to attain the resolution objectives. In case of financial contracts, this will most likely involve continuation of critical functions and core business lines. Third, severe market disruption could ensue from the application of bail-in. Fourth, value destruction resulting from bail-in is disproportionate or may adversely affect other creditors. Given the specificities and functions of financial contracts, it is not unlikely that resolution authorities are inclined to exclude financial contracts from the scope of the bail-in measure.

[51] "Secured liabilities" is defined as liabilities where the creditor [which could be the institution or its counterparty] is secured by collateral arrangements including liabilities arising from repurchase transactions and other title transfer collateral arrangements

(c) Short-term liabilities

This exception applies to all financial contracts with a tenor of fewer than seven days.[52] Not surprisingly, the legislator expressly excluded short-term liabilities from the scope of resolution measures. As discussed above, repurchase agreements commonly have a tenor of fewer than seven days. Moreover, the above discussion illustrates that these agreements are used for liquidity management. Subjecting repurchase agreements to the risk of becoming subject to bail-in could cause significant obstacles to procuring liquidity. This drain of liquidity when most needed would cause insuperable distress in the absence of additional sources of liquidity, such as public funds.

Other instruments such as derivatives, margin loans and securities lending agreements will also fall within this exception if they have a tenor of fewer than seven days. A repurchase agreement structured as an on-demand instrument can be deemed perpetual and thus not qualify for the short-term exception. Nonetheless, if the position is fully collaterised, it can still be protected under the fully secured liability exception analysed above.

(d) Liabilities with financial market infrastructures

Liabilities with certain financial market infrastructures are also carved out form the scope of bail-in, namely authorised and recognised FMIs. Consequently, third-state FMIs, which have not been recognised by the European Securities and Markets Authority, do not benefit from this protection. An implication is that liabilities with these FMIs can also be subject to bail-in. Since a third-state FMI will also require that the local laws govern the contract or membership agreement, a contractual recognition provision also needs to be included in the relevant contract or membership agreement.

5.1.2.3 Effects on financial contracts

It is desirable for the scope of application of bail-in to be as broad as possible. It should be reiterated that it is a precondition that the transactions are unsecured or not otherwise expressly exempted.[53] As stated earlier, the BRRD contains a permanent prohibition of some contractual rights linked to early termination based on recovery and resolution measures.[54] Similarly, the BRRD aims to effect a temporary suspension of certain close-out, acceleration and termination rights. As mentioned above, the purpose is to give the resolution authority the time necessary to determine and execute the resolution strategy.[55] As will be explored further below, the suspension is of the utmost importance in the case of financial contracts, as the time required to ascertain the value of the outstanding positions is an extensive exercise. Once the resolution strategy is determined and the value of the financial contracts ascertained, the safeguards should be observed. It is vital for the creditor hierarchy to be maintained. For instance, senior liabilities should be converted to equity, or written down or cancelled only after subordinate classes.

52 See Art 165 of Regulation 575/2013
53 Recital 70 of the BRRD
54 Recital 93 of the BRRD
55 Recital 94 of the BRRD

With respect to financial contracts, an essential safeguard is that protected arrangements, including close-out netting and collateral arrangements, shall not be disturbed.[56] In particular, section 48P(3) of the Banking Act 2009 empowers HM Treasury by order to (i) restrict the exercise of any power which might affect protected arrangements; (ii) impose conditions on the exercise of any power that might affect protected arrangements; (iii) require any instrument that makes special bail-in provision to include specified provision in respect of a protected arrangement; (iv) render an instrument void if it is made in contravention of an order under this section; and (v) develop principles which the BoE must observe in exercising powers that concern or affect protected arrangements. These rights have taken the form of the Banking Act 2009 (Restriction of Special Bail-in Provision, etc.) Order 2014 (the "Order").

In order to apply bail-in, Art 4(2) of the Order provides that netting arrangenements must be terminated in their entirety and not partially. The application of bail-in is contingent on the prior termination of the transactions. Art 4(6) of the Order empowers the BoE to exercise the close-out netting rights under the master agreements or alternativley, if not possible, under own terms. It confines these rights to situations where it is impossible to exercise the terms of the contract in accordance with section 48B(1) of the Banking Act 2009. Given that the valuation methodology may differ from the contractual terms, there is a risk that it falsely produces a net obligation for the institution under resolution which can be subject to bail-in. Thereby, the notion of protected liability could be qualified and undermined. Hence, protection can only be ensured to the extent that the transactions are not terminated early in order to be subjected to bail-in.

Given that the mark-to-market value does not constitute an actual obligation, implications arising from a mispricing are negligible. However, upon early termination the mispricing may materialise. All contingent rights and obligations in the form of deliverables, receivables and payables are converted and replaced by a single net amount. Naturally, this net value will indeed reflect the mark-to-market values. For certain assets, the valuation will be complicated and prone to errors. This will be particularly true in times of market-wide stress. In comparison to an orderly termination, there may be significant losses for the defaulting institution. These losses on early termination may be

[56] Section 48P of the Banking Act 2009 defines "protected arrangements" as security interests, title transfer collateral arrangements, set-off arrangements and netting arrangements. Each of these types of arrangement is further defined in the section, and these definitions are comprehensive enough to capture a broad range of netting, close-out netting and collateral arrangements that arise in the derivatives and other financial markets. Moreover, "protected liability" is further defined as follows by Art 4(2) of the Banking Act 2009 (Restriction of Special Bail-in Provision, etc.) Order 2014: "(2) In this article a "protected liability" is a liability which meets each of the following conditions— (a) Condition 1 is that the liability is owed by the relevant banking institution to a particular person ("the person"); (b) Condition 2 is that the liability is a liability which— (i) either the person or the relevant banking institution is entitled to set-off or net under particular set-off arrangements, netting arrangements or title transfer collateral arrangements into which the person has entered with the relevant banking institution ("the relevant arrangements"), and (ii) has not been converted into a net debt, claim or obligation, whether in accordance with the relevant arrangement or through the making of special bail-in provision or otherwise; (c) Condition 3 is that the liability relates to a derivative, financial contract or qualifying master agreement (see article 5). (3) For the purposes of paragraph (2), it does not matter whether— (a) the arrangement which permits the person or the banking institution to set-off or net the liability also permits the person or the banking institution to set-off or net rights and liabilities with another person; (b) the right of the person or the banking institution to set-off or net is exercisable only on the occurrence of a particular event."

exacerbated by depressed claims and augmented obligations. In practice, this is known as "jump-to-default".

Art 49 stipulates that the following should be considered in the valuation of financial contracts. Resolution authorities shall have regard to (i) appropriate methodologies for valuation, (ii) accepted principles in relation to the timing of the valuation, (iii) appropriate methodologies to assess expected losses. The European Banking Authority prepared the relevant methodologies, which, in principle, resemble those customary in relation to the master agreements. Beyond Article 49, there is a theoretical possibility for the valuation methodologies to differ. Irrespectively of the relevant provisions, resolution authorities are required to observe the netting, collateral or security arrangement. As explained above, under the presumption that defaulting institutions may face substantial losses due to early termination, the EBA appreciated the need to provide mitigating measures.

5.1.2.4 Implications for financial contracts

Application of the special bail-in instruments requires a report addressed to the Chancellor of the Exchequer. He will substantiate the relevant decision pursuant to section 48E(1) and (2) of the Banking Act 2009 as well as any departures from insolvency treatment principles.[57] The Treasury may safeguard the observance of the insolvency treatment principles by an order specifying matters or principles to which the BoE must have regard.[58]

This contrasts sharply with the treatment of counterparties to financial contracts in normal insolvency proceedings. The non-defaulting party has the discretion to designate a termination date or to rely on the flawed asset provision. Thus, there is a possibility that the default does not result in a payment obligation. In particular, if the close-out amount exceeds the value of the collateral, a payment obligation will arise for the non-defaulting counterparty. However, bail-in might also have a strategic reason, for instance if it is found that the position is likely to incur losses or if the transferred business does not require continuation of the financial contract position.

Pursuant to section 12A and 12AA of the Banking Act 2009, the BoE is empowered to make special bail-in provision, as part of a resolution instrument or alone.[59] Sections 48B to 48W of the Banking Act 2009 contain a necessary specification as regards implementation. Under these provisions: (i) it envisages the cancellation, modification or changing of the form of a liability owed by the financial institution, or (ii) the provision may effect that any specified right under the liability is considered to have been exercised by the financial institution. Section 48(B)(2) Banking Act 2009 provides the BoE with a blanket power allowing it to make any associated provision under section 48(3) Banking Act 2009. Before analysing the "lessons" for the treatment of financial contracts, the following should be reiterated. Depositors fall outside of the scope of the BRRD and Banking Act, provided they are holders of regulated deposits.[60] The other creditors will be repaid, depending on whether and how

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57 See section 48E(5)–(7) for further provisions about the report

58 Section 48G Banking Act 2009

59 Sections 48B–48W added by para 4 Schedule 2 to the Financial Services (Banking Reform) Act 2013

60 Protected creditors are those that qualify for deposit insurance provided by the Financial Services Compensation Scheme, up to the maximum level of protection. Any surplus can be subject to the resolution measures

their claim has been transferred, and whether the claim is secured or unsecured. In case of financial derivatives, securities financing transactions or structured finance arrangements, counterparties benefit from protection ensuring set-off or close-out netting of obligations. These counterparties thereby become creditors for any unsecured net amounts.

Operating liabilities are, amongst others, deposits and financial instruments as listed in the preceding paragraph, which are vital for the financing and execution of client transactions and the management of risk and liquidity. However, these financial contracts do not represent investments in the financial institution but are instruments for managing risk and liquidity. Therefore, the reduction of individual business lines will necessitate a rebalancing exercise in the form of an adjustment of positions by, amongst others, terminating certain transactions. The counterparties' confidence in the continuation of their business relationship will therefore be limited. This will apply in particular if counterparties use the transaction to hedge themselves against certain risks. Therefore, unlike financial creditors, trade creditors are more likely to terminate and determine a third party than to renegotiate in order to rebalance their position in anticipation of probable termination.[61]

These operating liabilities should receive a more beneficial treatment in resolution, since they can cause contagion and exacerbate financial distress. In contrast, financial liabilities arising from investments should form part of bail-in. Investors are prepared to accept the risk of partial repayment or complete loss of the invested capital in return for capital gain, dividends and coupon payments. Therefore, there should be a clear hierarchy of assets that are essential for the financial system and will need to be continued, while others should be used to finance or otherwise support recovery or orderly resolution. Insolvency does not provide for such measures when dealing with complex financial institutions. In relation to "simpler" financial institutions, viz. credit institutions and building societies, the legislator has proposed reforms to the current compensation system (FSCS) which would more effectively protect depositors in the event of failure.

5.2 Supplementary and ancillary powers

To promote the execution of stabilisation measures, the Banking Act 2009, together with the Code of Practice, provides various supplementary and ancillary powers.[62] These powers constitute overriding mandatory provisions within the meaning of the Rome I Regulation, i.e. provisions which apply notwithstanding the governing law of the financial contract.[63] This means that even if the laws of the chosen jurisdiction do not contain similar provisions, they will be implied and conflicting contractual provisions will be disapplied. The policy reason behind this is to safeguard financial stability in the EEA as well as to promote the attainment of the other resolution objectives. On

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61 This termination of transactions in anticipation of distress has received significant attention in the aftermath of the financial crisis. The reason is that widespread termination can increase the distress for the defaulting party. This situation is akin to a so-called bank run, in which depositors seek to withdraw and liquidate their accounts in anticipation that the distressed bank may be unable to fully repay the accounts. Although deposits are covered Financial Services Compensation Scheme, not the entire amount of the account may be covered, the depositors may be unaware of its existence or may fear operational difficulties when being compensated by the scheme

62 For an overview see HM Treasury, *Banking Act 2009: Special resolution regime code of practice* (revised 12 March 2015) paras. 7.21 sq

63 Art 68 of the BRRD

balance, though rarely invoked in capital markets, the mandatory provisions are intrusive and create uncertainty as the effect is difficult to assess. This problem is mitigated in the presence of guidance and appropriate safeguards, as will be explored in the following sections.

5.2.1 Stays, suspensions and termination restrictions

During resolution, the non-defaulting counterparty's ability to terminate is restricted. In fact, the ability terminate is reserved for the BoE but for a few exemptions. The policy reason is that termination can undermine resolution efforts. Hence, the purpose of giving the BoE some form of injunctive relief is twofold. First, it gives it a short period during which it can "cure" the distress, thereby permitting the financial institution or parts of it to continue operating as going concern. Second, it precludes that the resolution effort itself will constitute an event of default, as will be discussed below, thereby aggravating the distress experienced by the institution.

5.2.1.1 Stays and suspension

Stays and suspension rights are interrelated.[64] While stay means the ability to temporarily prohibit the exercise of termination rights in an ongoing resolution proceeding, suspension involves the ability to temporarily prohibit the performance of substantive obligations, payment and deliveries, including exchange of collateral. A temporary stay can either apply automatically or be invoked at the discretion of the BoE. Interestingly, automatic suspension requires that substantive obligations under the transactions be continued, such as payment, delivery and posting of collateral. It supplements resolution measures adopted by the BoE. Discretionary suspension, however, halts any transactions including substantive obligations. Both suspensions apply to the institution under resolution and the any creditors and counterparties. Hence, neither party has to honour its obligations for a limited period of time. All obligations become due once the suspension is lifted.

5.2.1.2 Termination restrictions

The BRRD disapplies termination events which are contingent on the commencement of recovery and resolution measures, including temporary suspension during the application of resolution measures.[65] To this effect, para. 10(9) of Schedule 3(3) to the Bank Recovery and Resolution (No. 2) Order 2014 substituted Regulation 34 of the Credit Institutions (Reorganisation and Winding up) Regulations 2004. As a consequence, although the relevant procedures shall be determined by the governing law of the netting agreement, this shall not preclude or impair the restriction or suspension of termination rights pursuant to sections 48Z and 70C of the Banking Act 2009, respectively.[66] Regulation 35 of the Bank Recovery and Resolution (No. 2) Order 2014 has been amended equally in relation to repos.

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64 Section 70A to D of Banking Act 2009, see the PRA Handbook on the Stay, available at http://www.prarulebook.co.uk/rulebook/Content/Chapter/318778/

65 "Without prejudice to Articles 68 and 71 of Directive 2014/59/EU, netting agreements shall be governed solely by the law of the contract which governs such agreements."

66 Pursuant to Regulation 34(3)(c) of the Credit Institutions (Reorganisation and Winding up) Regulations 2004, any provisions made in accordance with Arts 68 and 71 of the BRRD or EEA law transposing these provisions shall not be precluded or impaired due to the precedence of the contractual law over the statutory provisions

5.2.2 Duration

General sta\ys and suspensions under temporary stay are limited in time, i.e. lasting from the publication of the resolution notice until midnight of the following business day. The reason for their limitation is that a longer stay and suspension period was thought to constitute a potential source of systemic risk. Prolonged periods of suspended exchange of collateral can expose the financial institution under resolution and its counterparty to market volatility and loss of hedges. The consequences might be potentially detrimental to financial stability and affected entities. It may also be contrary to the Financial Stability Board's Key Attributes.[67] These envisage only general stay,[68] not least to ensure the continued functioning of vital mechanisms. Failure to provide collateral, important for the mitigation of market risk, and payments, crucial for liquidity management, should, therefore not inhibit the ability to exercise early termination rights.[69] Deviation from the Key Attributes' recommendations follows, amongst others, from the objective to apply bail-in against uncollaterised obligations. It suffices to note that the application of bail-in is complex and requires prior close-out. In this context, the ability to freeze values in order to ascertain potential liabilities is vital.

5.2.3 Implications for the regulatory recognition of credit risk mitigation techniques

The suspension period increases the margin period of risk, i.e. the risk of a shortfall in collateral due to an extended time between the last exchange of collateral and subsequent close-out. Should this period be too long, there will even be a risk that credit risk mitigation techniques are not recognised for capital charges purposes. Similar to other capital regulations, including the Dodd-Frank Act, the Capital Requirements Regulation stipulates that the ability to close out shall be ascertainable.[70] To reiterate, the CRR requires that credit risk mitigation techniques shall be enforceable in a timely manner.[71] Since neither the CRR nor the CRD IV provides a definition, such definition will depend on the particular credit risk mitigation technique and its context. A Banking Act 2009 moratorium or stay is unlikely to conflict with the CRR requirement. However, if it does not respect international standards, e.g. those set by the FSB, there will be a significant risk that it may affect the ability to transact with third-state entities. Nonetheless, the suspension may cause dislocation of hedges, exposing non-defaulting parties to potentially unlimited losses. Although there are various safeguards or compensation measures for creditors affected by resolution measures,[72] there are no such safeguards or measures for creditors affected by suspension.

5.2.3.1 Restriction of termination events

section 48Z of the Banking Act 2009 prohibits that recovery and resolution measures constitute enforcement rights. Thus, if a recovery and resolution measure[73] is initiated against a distressed

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67 Financial Stability Board, *Key Attributes* (October 2011 as revised and updated in October 2014)

68 Key Attribute 4.3 states that suspension shall be limited where substantive payment and delivery obligations of the contracts continue to be performed

69 See Appendix I, Annex 5 to the Key Attributes

70 See section 3.1

71 See Arts 194(4), 206(b), 213(1)(c)(iii) and 286(3) para 2

72 See section 5.3

73 Often referred to as crisis prevention measure and crisis management measure. A crisis prevention measure is a direction to address material deficiencies in the recovery plan or to reduce obstacles to its implementation by the competent authority such as the PRA or FCA, pursuant to Art 6(6) of the BRRD, or a direction to remove obstacles to resolvability by the resolution authority such as the Bank of

financial institution, the measure itself will not be capable of constituting a default event as is any other contingency that is linked to a recovery and resolution measure. Under this prohibition, enforcement actions against subsidiaries or branches resulting from recovery and resolution measures against the parent undertaking will also be void.[74] This prohibition follows from the rationale that cross-default provisions at subsidiary or branch level may indirectly result in termination at parent level.

Maintaining certainty requires that the entities subject to the resolution measure continue to perform their substantive obligations. Thus, if a resolution measure is initiated but the resolution authority fails to make due payments or deliver collateral, the counterparty can enforce its early termination and enforcement rights. However, the BoE has the authority to disapply the termination rights even if the performance of substantive obligations is discontinued or if it chooses to effect a mandatory a resolution measure such as a bail-in or transfer measure.[75] The latter measure allows the resolution authority to override contractual restrictions relating to the transfer of the contract.

5.2.4 Enforcement and termination rights

Under general insolvency law, there is no presumption of a prohibition of *ipso facto* clauses. This means that it is permissible to terminate in anticipation of or due to the counterparty's insolvency. As a response to the financial crisis, this presumption was reconsidered. Although there is some risk of default, recovery and resolution measures seek to ensure partial or full continuation of the distressed financial institution. Since the effect of credit risk mitigation techniques on the defaulting party is akin to a disorderly run-on-the-bank, it has been argued that recovery or resolution measures should not serve as enforcement events.

5.2.4.1 The exercise of close-out by the Bank of England

At any time during resolution, the BoE can seek to close out or accelerate transactions, thus serving the execution of the resolution strategy. For instance, in context of the transfer powers, neither the transferee nor the residual institutions under administration or liquidation may require a certain portfolio. As a general principle and to protect legal certainty, the BoE may be expected to exercise this power only in exceptional circumstances. Importantly, it will only do so in accordance with the terms of the relevant master agreement. The valuation methodology provided under the relevant regulatory technical standards was developed for the purpose of bail-in only.[76] Close-out for

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England, pursuant to Art 17 or 18 of the BRRD. In addition, the FCA and PRA may initiate recovery measures as set out in Art 27 of the BRRD; recapitalisation may be initiated by the Bank of England by instigating the measure under section 6B of the Banking Act. A crisis measure, on the other hand, is the exercise of extensive stabilisation actions by the Bank of England or the Treasury, such as the appointment of a resolution administrator under section 62B of the Banking Act, initiation of a third-state resolution action if recognised under the BRRD (see section 89H(2)(a) of the Banking Act 2009), or the exercise of a resolution measure by the Bank of England assisting a third-state resolution

74 In limited circumstances, it is possible to terminate and enforce, namely when: (i) the subsidiary is not guaranteed or supported by the parent undertaking subject to resolution, or (ii) the contract contains no cross-default clauses or can trigger cross-default provisions in other contracts

75 Subject to the safeguards set out in the Banking Act 2009 (Restriction of Partial Property Transfer) Order 2009

76 See Regulation 2016/1401 of 23 May 2016 supplementing Directive 2014/59/EU of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms with regard to regulatory technical standards for methodologies and principles on the valuation of liabilities arising from derivatives, and European Banking Authority, *Final*

measures other than bail-in would not satisfy the grounds for derogation from the terms of the master agreement.

In any case, if the resolution authority closes out, it serves primarily as an ancillary power to implement stabilisation options. Affected creditors solely have recourse to the no-creditor-worse-off ("NCWO") principle. It is doubtful whether the fact of being out-of-the-money at close-out will suffice to bring an action for the alleged breach of the no-creditor-worse-off principle. A succesful action requires an additional measure based on the authority's discretion which causes the relative worse treatment. Consequent bail-in of the uncollaterised close-out amount could constitute such an event. In other words, there must be greater losses ordinarily arising from the transaction and its termination.

5.2.4.2 Prejudicial valuation

Determining the value of derivatives transactions is complex and subject to a myriad of assumptions.[77] To expedite the valuation procedure or if it cannot be carried out in accordance with the terms of the agreement, the BoE or an independent third party will complete the valuation in two steps.[78] First, there will be a pre-valuation to help ascertain probable claims and obligations, thus assisting in devising a resolution strategy.[79] The purpose of this valuation is to rapidly determine a close-out amount in conjunction with the envisaged stabilisation measures. This presumably only applies to bail-in as transfer does not require a valuation. This will be followed by a second valuation shortly before or after the stabilisation option is applied. This serves to ensure that the valuation does not materially deviate from the result of the master agreement. It should be pointed out that a close-out amount needs to be determined only upon termination, as the valuation will take the replacement value into account. Novation to a transferee does not require such close-out.

5.2.5 Henry VIII clause

Under the Banking (Special Provisions) Act 2008, the Treasury was given the power to disapply or modify statutory provisions or the rule of law.[80] This extraordinary power is based on the premise that extraordinary times require extraordinary efforts. Such power is appropriate when the legislator, Treasury or BoE are faced with the need for prompt intervention and legal obstacles. An order was made for the disapplication of certain provisions of the Companies Act 2006, with retrospective effect.[81] It could thus be ensured that the share transfer intended by the BoE took immediate effect, without requiring shareholders' consent.

Draft: Regulatory technical standards on valuation for the purposes of resolution and on valuation to determine difference in treatment following resolution of credit institutions and investment firms (EBA/RTS/2017/05, 2017)

77 Ibid

78 See section 55(1) to (5) and (7) to (10) and section 62 of the Banking Act 2009

79 European Banking Authority, Final Draft: Regulatory technical standards on valuation for the purposes of resolution and on valuation to determine difference in treatment following resolution of credit institutions and investment firms (EBA/RTS/2017/05, 2017)

80 See section 4.1.1

81 Barney Hearnden and Jane Whitfield, ' The Banking Act 2009' (2009)3 Corporate Rescue and Insolvency p. 94

This extraordinary power has been retained and is now enshrined in section 75 of the Banking Act 2009. As an incidental function to the stabilisation power, the Treasury is empowered to amend laws with a view to achieving or facilitating the execution of an action related to the resolution objectives since 16 December 2016.[82] It permits amending primary and secondary legislation as well as provisions of common law other than the Banking Act 2009 itself.[83] Given the width of the power, it may be inferred that the construction of this provision is narrow.[84] For the construction, the Treasury must consider the general resolution objectives and purpose of the Banking Act 2009. Any contravention of the intention of the Parliament will consequently be *ultra vires.*[85] Speaking about the legitimacy of Henry VIII clauses in general, Earl Russell asserted that there was a general presumption against the invoking of such clauses and the burden of proof was "heavy".[86] In the words of Alistair Darling, former Chancellor of the Exchequer, the extraordinary power should enable making necessary modifications "in relation to the competition regime or … insolvency legislation"[87] and may require, as in the Dunfermline case, retrospective application.[88] This broad power rebuts strong presumptions that may undermine the rule of law.

5.3 Third-state governing law or jurisdiction

In the previous subsection we have seen that supplementary and ancillary powers that override contractual rights qualify as mandatory provisions under the Rome I Regulation.[89] This applies irrespective of the governing law, including third-state governing laws. There will be a problem, however, if a party is not subject to the Rome I Regulation and seeks termination and enforcement. Unless there are memoranda of understanding between the relevant EEA Member and a third state, the resolution authority's right to stay or suspend rights, or to transfer or apply bail-in will be accordingly limited.

The experience during the financial crisis showed that competent authorities face significant problems when dealing with foreign counterparties or where the governing agreements are subject to a non- European Economic Area (non-EEA) law. The new regime is *de facto* only applicable to agreements governed by the laws of England and Wales or another EEA jurisdiction. Application cannot be ensured as regards contracts governed by a non-EEA law or with a non-EEA court jurisdiction clause. Consequently, such non-EEA law agreements were not bound by either the bail-in regime or the restriction on the exercise of termination rights and security interests. The BRRD provides, in Art 55, that all liabilities (unless explicitly excluded) should incorporate language in the non-EEA law agreements to recognise the application of the bail-in tool by an EEA authority. In

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82 See section 75(2) of the Banking Act 2009

83 See also See HM Treasury, *Banking Act 2009: Special resolution regime code of practice* (revised 12 March 2015) para 7.21

84 Strict construction implies that any doubt must be resolved against the Government

85 Henry VIII clauses are controversial (see House of Lords debate on 3 February 2009 http://www.publications.parliament.uk/pa/ld200809/ldhansrd/text/90203-0003.htm.) and rare; however, there is no restriction under the principles of English public law. During the legislative procedure, these powers receive heightened scrutiny by Parliament

86 Hansard, HL Series 5, HC Vol.514, col.611 (16 January 1990)

87 Hansard, HC Vol.480, col.704 (14 October 2008)

88 See also HM Treasury, Banking Act 2009: Special resolution regime code of practice (revised 12 March 2015) para. 7.23

89 See section 5.1.2

sections 70C and 70D of the Banking Act 2009 that termination rights may be temporarily suspended and that banks should be required to include recognition clauses to that effect. Lastly, the Act prohibits that both crisis prevention measures and crisis management measures, or any related events, can be subject to termination clauses.

Resolution measures in relation to liabilities governed by the laws of a third state or otherwise subject to the jurisdiction of the courts of a third state may fail for various reasons. A primary reason is that third-state authorities may not give effect to or may restrict the application of Banking Act 2009 measures. This reluctance may be a consequence of a conflict between the measure and contractual rights that are permissible and protected under the laws of the third state. As regards financial institutions, Articles 61(1) and 54 of the Bank Recovery and Resolution (No 2) Order 2014 empower the resolution authority to resolve substantial impediments to resolution. Should significant exposure or operations be governed by or subject to the jurisdiction of a third state, a resolution authority may order amendment or relocation. This power applies to all financial contracts, notwithstanding probable exclusion in accordance with the protections and restrictions listed in sections 48 and 75 of the Banking Act 2009. Any financial contracts and arrangements may be subject to intended undercollateralisation, which will allow the application of bail-in.[90] More important, however, are the temporary stay of termination rights and the possible application of other resolution measures, such as the various transfer tools.

5.3.1 Contractual clauses

The PRA Handbook[91] stipulates apposite requirements for agreements that may form liabilities and are governed by the laws of a third state. These agreements must contain contractual terms that express the recognition and acceptance of probable resolution measures, including bail-in. This contractual tool to promote resolvability is, however, challenging for market participants. Failure to include a provision to this effect does not preclude application of resolution measures *per se*. In fact, where the liabilities are located within the jurisdiction of the resolution authority, the resolution measure can be freely exercised. However, if rights are located or exercised beyond the jurisdiction of the resolution authority, that authority's hands will be tied in the absence of a contractual recognition provision or subject to subsequent challenge.

Recognition provisions must fundamentally distinguish between the application of primary and ancillary measures. In effect, the application of primary measures, such as the bail-in tool, will not depend on the introduction of language in the agreements governing the liabilities that facilitates the execution. If the liability is located in the UK, the BoE has, under the Banking Act 2009, sufficient powers to override any contractual provisions to the contrary. In the context of the Minimum Requirements for Eligible Liabilities ("MREL") or Total Loss-Absorbing Capacity ("TLAC"), the PRA may require that sufficient debt instruments are issued in the UK or another Member State that recognises the resolution measures. With respect to other liabilities and third states, however, it

[90] Sections 47 and 48 of the Banking Act 2009
[91] Rule 2.1 of the PRA Handbook: Contractual Recognition of Bail-in

alleviates the potential implications for an affected creditor seeking an injunction or temporary relief abroad. Such action in a third state may frustrate the application of the resolution measure.

5.3.2 Scope

In the realm of financial contracts, the most critical factor is the potential to terminate some or all of the transactions with the distressed counterparty. Termination in contravention of regulatory powers could before the introduction of the Banking Act 2009 only be regulated within England with the above mentioned requirement for approval. During the financial crisis, non-defaulting counterparties had to seek regulatory approval to be able to enforce their termination rights. Enforceability of this regulatory approval approach could only be ensured for domestic counterparties. However, the enforceability of resolution measures affecting counterparties located abroad may vary. Even within Europe enforcement has been challenging, as recognition frameworks require court approval, which can be a lengthy process. Moreover, authorities in third states concerned about domestic effects are reluctant to recognise foreign measures. Given the (almost) instant termination and other mechanism under the master agreement, the need for a pre-emptive measure is salient.

The extraterritorial effect is therefore a novelty. It comes as no surprise that only entities within the jurisdiction of the BoE can be made subject to the Banking Act 2009's requirements. Hence, the employed regime requires that the Bank can impel entities within its jurisdiction to incorporate language in their master agreements that counterparties recognise and accept to be bound by the resolution measure or any ancillary measure executed by the BoE. It is noteworthy that the requirements apply to all liabilities, including those that are excluded by the Banking Act 2009 such as secured liabilities. The mere fact of recognition, however, does not change the exclusion, which means that only uncollaterised liabilities are subjected to the resolution measure.

Complying with the above requirement to coerce counterparties to recognise and accept to be bound by (ancillary) measures of the Banking Act 2009 represents due to the far-reaching implications and broad scope, a tremendous practical challenge for financial institutions. Intuitively, it can be inferred that recognition suggests that the counterparty is willing to incur an additional layer of risk, in the absence of any compensation. Compliance with the requirement was therefore staggered. With regard to primary resolution measures, such as bail-in, the effective date specified in the Banking Act 2009 was 1 January 2016. Given the eagerness to prevent future bail-outs while ensuring availability of funds for restructuring, the English legislator (as did the other Member States) pre-empted the effective date by one year.

The PRA devised the notion of impracticality. It means that if a PRA-regulated entity deems the inclusion of resolution stay and bail-in recognition impossible, it may disregard that requirement. This may be well the case with regard to the PRA rules and agreements with central counterparties ("CCPs"). In these cases, it is difficult to amend existing agreements and the very application of resolution measures would moreover be counterproductive, because that the relevant liabilities are somewhat theoretical rather than do not constitute tangible obligations. Moreover, foreign authorities may be reluctant to recognise stabilisation options exercised by the BoE. However, its application

needs to be carefully considered. The PRA provides some guidance as to when it can be applied.[92] This guidance is very narrow and invoking the notion of impracticability is challenging. The PRA Handbook also stipulates that resolution authorities may request banks to provide legal opinions about the legal enforceability and effectiveness of their recognition clauses. Market practice regarding these opinions seems inconsistent, although some opinions cover bail-in clauses and provide qualifications about the resolution measure. The general presumption is that parties that consented to the bail-in measure are deemed to be bound by it, unless national legislation renders this measure void). Since rights of counterparties, and thus procedural and statutory rights under local law, are affected, crucial public policy questions arise. Moreover, there is considerable room for improvement in the relevant opinions.

5.4 Insolvency regimes under the Banking Act 2009

The English modified regimes resemble ordinary insolvency law with the difference of incorporating lessons from the financial crisis. It permits producing more viable solutions. The BoE can initiate bank resolution proceedings and petition the court to commence insolvency and administration proceedings contained in the Banking Act 2009.[93] Altough the latter regimes resemble procedures under conventional insolvency law, their primary objective is to protect and promote financial market stability. These special proceedings sit alongside conventional insolvency procedures, which can be instigated if the prerequisites set by the modified regime are not satisfied and the financial institution is insolvent.[94] In fact, the BRRD contains no equivalent provisions. Although the resolution tools of the BRRD also provide that certain assets, liabilities and properties may be transferred, the BRRD fails to recognise that it may be impossible to transfer deposits. Therefore, the objective of insolvency proceedings needs to be aligned with that of resolution, which includes continuing servicing part of the transferred parts of the institution and expediting the return of client assets.

The failure to adapt insolvency laws inhibits the ability to contain contagion since it fails to militate against depositor runs. Thus, while assets, liabilities and property may be transferred under the BRRD, the insolvency measures ensure that the deposits function is maintained in insolvency or administration and allow a subsequent transfer if a suitable transferee is identified. Similarly, if certain assets and liabilities are not transferred, the insolvency or administration proceedings may be initiated against the residual entity. The proceedings relating to banks and investment banks also ensure a rapid return of assets held by the bank or investment bank in a fiduciary capacity, ultimately

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92 See http://www.bankofengland.co.uk/pra/Pages/publications/ss/2016/ss716.aspx and the policy statement (Policy Statement | PS17/16) available at http://www.bankofengland.co.uk/pra/Documents/publications/ps/2016/ps1716.pdf and the foregoing consultation (Consultation Paper | CP8/16) available at http://www.bankofengland.co.uk/pra/Documents/publications/cp/2016/cp816.pdf

93 See Bank of England, HM Treasury the Financial Services Authority, *Financial stability and depositor protection: further consultation* (Cm 7436, 2018) para 1.48. For a European overview see Andrea Miglionico, 'Restructuring Failing Banks for Economic Recovery: In Search of an International Insolvency Regime' (2017) 14(5) International Corporate Rescue

94 A common belief is that small financial institutions will be subject to conventional insolvency. However, the English experience has shown that even small mortgage banks may require the modified regime, in particular if depositors are affected, see Malcolm Cohen and Shane Crooks, 'Bank failures under the Banking Act 2009' (2012) 9(2) International Corporate Rescue p. 127 and Mike Pink, 'Dunfermline Building Society: The First Use of the New Resolution Powers under the Banking Act 2009' (2010) 7(3) International Corporate Rescue

promoting financial stability. This contrasts with other conventional proceedings, which seek to maximise insolvency dividends and ensure an equitable distribution.

5.4.1 Credit institutions

Both the bank liquidation proceedings set out in Part 2 and administration proceedings set out in Part 3 of the Banking Act 2009 are based on existing provisions.[95] If a credit institution experiences distress that may result in insolvency, the BoE can apply to the court to initiate bank liquidation and administration proceedings.[96] This means that following application of the stabilisation options, i.e. when the primary objective has been achieved, bank administration or bank insolvency proceedings can be initiated against the residual institution. The objective of bank administration and insolvency is continuity of essential services, systems, contracts and facilities that cannot be transferred with the other assets and liabilities. Together, this forms the first objective, ensuring that depositors are protected and the bridge institution or private sector purchaser is served. The second objective, over which the first takes precedence, resembles that of ordinary insolvency laws. This hierarchy indicates that the public interest ranks above the creditors'.

5.4.1.1 Bank insolvency

The commencement of insolvency proceedings, in contrast to administration, requires that the debtor is unable to pay its debts, i.e. not merely likely to be unable to pay its debts, or is failing, or is likely to fail, to meet the threshold conditions under the Financial Services and Markets Act.[97] This requirement constitutes ground (A). In addition, the modified regime demands that the following two grounds (B) and (C) are satisfied: (B) the winding-up of the bank is in the public interest, and (C) it is fair to wind up the bank. If these grounds are not met, courts can only order the commencement of liquidation proceeding under ordinary insolvency law.

Proceedings can be instigated by court order, irrespective of the application of resolution under Part 1 of the Banking Act 2009.[98] The objective is to protect eligible depositors by primarily effecting the transfer of accounts or the prompt compensation with recourse to the Financial Services Compensation Scheme.[99] Furthermore, the liquidator must observe and give priority to achievement of Objective 1 in exercising his powers.[100] The right of an aggrieved stakeholder to bring an action is suspended until Objective 1 has been achieved "insofar as is reasonably practicable" to prevent any delay in the proceedings.[101] This suspension is akin to a moratorium in that the relevant exemptions apply by analogy. This includes, for instance, actions to conserve obligations that became due before the proceedings. Such suspension may affect the right to enforce obligations that become due during

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95 The Bank Administration (England and Wales) Rules 2009 (SI 2009/357) give effect to the bank administration procedures in the Banking Act, and are based on the rules governing administration set out in the Insolvency Rules.

96 For the first experience with the bank liquidation procedure, in connection with Southsea Mortgage & Investment Company Limited, see Malcolm Cohen and Shane Crooks, 'Bank failures under the Banking Act 2009' (2012) 9(2) International Corporate Rescue p. 127

97 Section 41(1) of the Financial Services and Markets Act ("FSMA")

98 Section 90(2)(a) of the Banking Act 2009

99 Section 90(2)(c) of the Banking Act 2009

100 Sch 4 to the Insolvency Act1986

101 Rodrigo Olivares-Caminal, John Douglas, Randall Guynn, Alan Kornberg, Sarah Paterson, Dalvinder Singh, Hilary Stonefrost, *Debt Restructuring* (Oxford University Press 2011) p. 300

the proceedings but for narrow exemptions such as those provided by the Financial Collateral Arrangements Regulations.[102]

Overall, it can be stated that the focus has shifted. The treatment of creditors is subordinated to that of depositors. This ranking is not unusual. In the case of an insolvent insurance fund, policyholder claims are satisfied before general creditors' claims. However, financial institutions provide multiple services, meaning that various transactions may exist between the creditors and the distressed financial institution, including deposits. Hence, the question arose whether deposits qualify for set-off.[103] In bank insolvency, the return of eligible deposits, i.e. those protected by the Financial Services Compensation Scheme,[104] do not form part of the set-off.[105] Thus, only monies of investment funds or other financial institutions as well as companies or natural persons in excess of the statutory maximum compensation can be used to set off their claims. The rationale is that priority is given to return or transfer of protected deposits.

5.4.1.2 Bank administration

The Banking Act 2009 Explanatory Notes[106] state in respect of Part 3:

> This Part establishes a new bank administration procedure for use where there has been a *partial transfer* of business from a failing bank. A bank administrator may be appointed by the court to administer the affairs of an insolvent residual bank created where part of a bank has been transferred to a private sector purchaser or to a bridge bank under the SRR. There are also powers to extend the procedure to building societies or credit unions.

In other words, Part 3 solely becomes effective subsequent to the application of Part 1,[107] because it should facilitate the transferees' operation of the services or facilities in respect of the "non-sold or non-transferred" part of the bank.[108] Commencement of administration proceedings, in contrast to liquidation, requires that the residual entity is unable, or likely to become unable, to pay its debts.[109] Unlike bank insolvency proceedings, only the BoE can petition for the opening of such proceedings, as this authority must determine whether it is essential for the implementation and realisation of the resolution strategy.

5.4.2 Building societies

Proceedings commenced against failing building societies, i.e. building society insolvency and building society special administration,[110] resemble those instituted against banks. Commencement

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102 See section 3.2

103 See *Kaupthing Singer & Friednlander Limited (in administration)* [2009] EWCA 2308

104 Those are deposits of natural persons as well as small and medium-sized companies with up to the statutory maximum of EUR 750,000 or its equivalent

105 Rule 72 of the Bank Insolvency (England & Wales) Rules 2009

106 Emphasis added

107 See section 136(2)(a) of the Banking Act 2009, which stipulates that it "is used where part of the business of a bank is sold to a commercial purchaser in accordance with section 11 or transferred to a [resolution company] 1 in accordance with [section 12 or 12ZA] 2 (and it can also be used in certain cases of multiple transfers under Part 1)"

108 Section 136(2)(c) of the Banking Act 2009

109 The court found in *Re Colt Telecom Group plc* [2002] EWHC 2815 (Ch) that the test is "more probable than not" that the debtor will be unable to pay its debt within the meaning of section 123 and para 111(1) of Sch B1 to the Insolvency Act 1986

110 See Building Societies Act 1986; Building Societies (Insolvency and Special Administration) Order 2009 (SI 2009/805); Building Society Insolvency Rules 2010 (SI 2010/2581) and Building Society Special Administration (England and Wales) Rules 2010 (SI 2010/2580)

requires satisfaction of the same conditions. The objective of building society administration and insolvency is continuity of essential services, systems, contracts and facilities that cannot be transferred with the other assets and liabilities. It ensures that depositors are protected and the bridge institution or private sector purchaser is serviced. The commencement of insolvency proceedings, in contrast to administration, requires that the residual entity is unable to pay its debts and is not merely unlikely to be unable to do so.

A difference with bank administration and the traditional insolvency regime is the special administrator's ability to disclaim onerous property pursuant to section 178 of the Insolvency Act[111] and to bring an action relating to wrongful trading pursuant to section 214 of the Insolvency Act. Other differences reflect the practical and legal distinctions between credit institutions and building societies.[112]

5.4.3 Investment firms and investment banks

The framework to resolve distressed investment firms and investment banks varies enormously from that applicable to credit institutions and building societies. An essential difference between investment firms and investment banks,[113] on the one hand, and credit institutions, on the other, is the presence of eligible deposits. While the former may be licensed to accept client monies and assets, the relevant accounts are not eligible for protection by the Financial Services Compensation Scheme.[114] Should the investment firm or investment bank have the necessary permission to accept eligible deposits, it will be treated as a credit institution, i.e. all parts of the Banking Act 2009 can be applied. A resolution strategy will presumably envisage the separation of the investment from the credit business. A residual institution without a valid licence to accept deposits will therefore be administered under the proceedings set out below.

For the present purpose, it should be noted that investment firms and investment banks are very active participants in financial contract markets. Hence, their failure can have other ramifications than that of credit institutions.[115] Therefore, it is germane to discuss the background and objective of the regimes applicable to investment firms and investment banks. It shall be noted that the restriction or regulation of their transactions does not come within the purview of special administration.

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111 The principles regarding determination where a contract is unprofitable and shall be disclaimed is that it imposes a continuing financial obligation which may be deemed detrimental to the general body of creditors, see *Re SSSL Realisation (2002)* Ltd [2006] EWCA Civ 7

112 See section 158 of the Banking Act 2009

113 Investment bank is defined in section 232 of the Banking Act 2009. It is an institution which is permitted to carry on the regulated activity of safeguarding and administering investments and dealing in investments as principal or agent pursuant to Part 4A of the Financial Services and Markets Act 2000

114 See the permission to carry on the regulated activity of accepting deposits under Part 4A of the Financial Services and Markets Act 2000

115 The failure of credit institutions can result in contagion, whereby deposits are withdrawn irrespective of the health of a credit institution but based on the fear that a failure of one financial institution may affect another financial institution

5.4.3.1 Background

The litigation that ensued upon the commencement of the administration procedure against Lehman Brothers International (Europe),[116] the principal European trading company in the Lehman Brothers group, exemplified the complexity of managing and containing distress of significant financial institutions.[117] In December 2009, HM Treasury published a consultation entitled "Establishing Resolution Arrangements for Investment Banks".[118] The executive summary of this consultation states that there is wide consensus and no doubt that the most critical phase of the financial crisis began after the collapse of Lehman Brothers on 15 September 2008. In particular, the financial crisis challenged existing regulatory and legal structures such as the existing restructuring procedures. The administration procedure under the Insolvency Act was commenced against the Lehman entities incorporated in England.[119] It transpired that there were "special and significant issues involved in the collapse of large and complex investment firms, especially where there are cross-border aspects to the business".[120] The response was a revision of the administration procedure applicable to complex financial institutions. The consultation proposed three objectives for the new framework, namely (i) facilitating the return of client money and assets, (ii) managing counterparty exposures, and (iii) providing sufficient protection to creditors.

The principal reason justifying the introduction of the special administration procedure is minimisation of disruptions to financial markets in the UK. The litigation in the aftermath of the collapse of Lehman Brothers revealed various challenges regarding client assets. Firstly, there was the challenge of determining whether money that Lehman's held was client money or money available to the general body of creditors.[121] Secondly, the mechanism for returning client assets was inappropriate.[122] Thirdly, reconciling differences between English law and the law of New York posed significant obstacles.[123] Fourthly, the complexity of the operations and the lack of or inadequate documentation complicated the identification of client assets.[124] The special administration procedure thus has two main objectives. The first objective is to provide the administrator with more 'clarity and direction' to ensure that the administration process is reducing the involvement of courts. For instance, the administrator is not required to make multiple applications to the court for directions, with the benefit of reducing cost and disruption.[125] The second

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116 An unlimited company organised under the laws of England and Wales

117 See Joanne Braithwaite, 'Law after Lehmans' (2014) LSE Law, Society and Economy Working Papers 11/2014

118 www.hm-treasury.gov.uk/consult_investment_banks2.com in September 2010

119 See Ch 2 of the consultation entitled "Establishing Resolution Arrangements for Investment Banks"

120 Andrew Campbell and Paula Moffatt, 'Dealing with financially distressed investment banks: the new "rescue" proposals' (2011) 1 Journal of International Banking and Financial Law p. 34, p. 34 ("Campbell and Moffatt")

121 See *Re Lehman Brothers International (Europe) (in administration)* [2010] EWCA Civ 917. It was held, under the terms of Chapter 7 of the Client Assets Sourcebook Rules ("CASS Rules"), that a statutory trust was created upon receipt of client money. Client money formed part of the pooled assets, whether segregated or not, and would be shared on a claims and not a contributory basis

122 See Re Lehman Brothers International (Europe) (in administration) (No 2) [2009] EWCA Civ 1161. The Court of Appeal held that where assets are held on trust by LBIE for its clients, these assets cannot be distributed under the terms of a Companies Act 2006 scheme of arrangement

123 See *Perpetual Trustee Co Ltd v BNY Corporate Trustee Services Ltd* [2009] EWCA Civ 1160 and *Lehman Brothers Special Financing Inc v BNY Corporate Trustee Services Limited* Ch 11 Case No. 08-13555. Adv. No. 09-01242

124 Ibid and *Re the Insolvency Act 1986* [2009] UKSC 2

125 Campbell and Moffatt (n 120) p. 36

aim is to provide confidence to clients and other financial market participants, thereby containing risks to financial stability. The special administration procedure does not represent a "significant shift of direction for UK insolvency law".[126] It merely replicates parts of the Insolvency Act and adapts certain provisions.

5.4.3.2 Special administration

The Investment Bank Special Administration Regulations 2011 entered into force in February 2011. They were considered an essential response to the onerous process of returning client assets in the Lehman Brothers' administration and have since been applied on various occasions.[127] In the Lehman Brothers' administration, the administrator had to apply the mechanism contained in the Insolvency Act which required various related court applications.[128]

The Investment Bank Special Administration Regulations 2011 provide for two procedures: (i) the special administration (bank insolvency) procedure and (ii) the special administration (bank administration) procedure. The interaction between the two procedures on the one hand and the investment bank special procedure on the other is unclear. It is suggested, however, that the special administration (bank insolvency) and (bank administration) procedures are merely iterations of the investment bank special procedure. The special administration (bank insolvency) and (bank administration) procedures may be applied exclusively to investment firms that accept eligible deposits. Investment firms that do not do so can be restructured under either administration (bank administration) or investment bank special administration.

The special administration regime is complemented by the Investment Bank Special Administration (England and Wales) Rules 2011, akin to the Insolvency Rules, and incorporates certain provisions of the Schedule 1 to the Insolvency Act 1986. The regime promotes confidence due to its familiarity. It introduces the following provisions which consider the special needs of financial firms. It abolishes the ceiling of one year for administration proceedings, introduces the measure of disclaimer, and to pursue fraudulent and wrongful trading actions. This right was traditionally reserved for liquidators. Moreover, ensures the continuity of supply of infrastructure and data services required to attain the objectives of special administration and to avert market disruptions.

(a) Objective

Administration has three objectives. The first is ensuring the return of client assets as soon as is reasonably practicable. The second is ensuring timely engagement with market infrastructure bodies and the authorities. The third is rescuing the investment bank as a going concern or wind it up in the best interests of the creditors. In case of systemically important investment banks which do not accept eligible deposits,[129] the administration provisions set out in the Insolvency Act 1986 will apply,

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126 Ibid

127 Examples include MF Global Limited (a large financial derivatives broker), Pritchard Stockbrokers Limited (a stockbroking company), WorldSpreads Limited (a financial trading company), and Fyshe Horton Finney Limited (a stockbroking company)

128 Joanne Rumley and Tim Pritchard, 'Investment Bank Special Administrations — so special they cannot be improved?' (2013) 5 Corporate Rescue and Insolvency p. 121

129 See Banking Act 2009 (Exclusion Investment Firms of a Specified Description) Order 2014 (SI 2010/1832)

subject to certain modifications as enumerated in the Bank Special Administration Regulations 2011. The investment bank special administration regime envisages two separate proceedings: special administration (bank insolvency) and special administration (bank administration).[130] The purpose is not maximisation of insolvency dividends and their equitable distribution but promotion of financial stability. In case of investment firms, the regime aims to promptly return of client assets and interaction with market infrastructures. In case of credit institutions or building societies, there are no similar requirements. The investment bank special administration regime reflects the unique feature that defines investment firms, namely the importance of client assets. Once client assets have been returned, the objectives contained in ordinary insolvency law will be pursued.

(b) Conditions

The special administration measures will be applied once the distressed financial institution meets any of the following three grounds. It must be proven that (i) the investment firm either is, or is likely to become, unable to pay its debts, (ii) it would be 'fair' to put the investment bank into special administration, or (iii) it is 'expedient in the public interest' to put the investment firm into special administration. A court order will instigate the proceedings. In contrast to the other modified regimes, the distressed institution, its directors and even creditors can petition not only the relevant authorities but also the court.

(c) Measures

The last objective is broadly in line with the administration objectives set out in Art 3 of Schedule B1 to the Insolvency Act. It means that where the administrator considers that there is no alternative to winding up the bank, he will be able to do so without the need for a conversion to liquidation. This provides for the possibility of a 'rescue' while at the same time recognising that, in most cases, such an outcome will not be a realistic possibility. It indicates that special administration has a dual aspect, i.e. protecting client assets and the traditional objective of ensuring continuance or at least maximisation of the estate's value and hence distribution of insolvency dividends to creditors.[131] This marks the need for a special regime which prescribes that it should be taken "as soon as is reasonably practicable". Undoubtedly, the introduction of such wording suggests "urgency",[132] which is difficult to reconcile with the general position of the insolvency administrator being faced with significant uncertainties as to the clients and their claims. The combination of these objectives is also trying to reconcile with the return of client assets inevitably means reduction of estate value and thus probable shortfalls in distribution.

These provisions provide statutory clarification that the costs of dealing with client assets are to be paid out of those assets (rather than out of the company's assets) and empower the administrator to deal with a shortfall of client investments and set a deadline for filing requests for payment of administrative claims, known as "bar date".[133] This power is vital because it allows the administrator

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130 See section 232 of the Banking Act 2009

131 Ibid

132 Ibid

133 It forms part of a global development requiring the posting of security to reduce credit risk, such as the initial and variation requirements under the European Market Infrastructure Regulation ("EMIR"). Somewhat counterintuitive, the posting of security can cause additional credit risk, as the security needs

to expedite the return of client assets.[134] A traditional distribution would be guided by inadequate trust law principles, which is more time-consuming and prevents a more equitable pro-rata distribution in the case of a shortfall of assets. Affected clients become unsecured creditors for the shortfall. In contrast, the special administration mirrors the enforcement of creditor claims. Nonetheless, transfer of the transactions and securities to a third party may be preferable.[135] This approach facilitates continuation of essential services, as advocated by Eva Hüpkes,[136] after application of the stabilisation options and the return of client assets and client money. The combined effect is protection of financial stability. It is therefore indispensable as an ancillary or even complementary measure to financial institution resolution. In addition, in the absence of a modified insolvency regime, the ability to reorganise or liquidate is elusive, and the effect of the BRRD is undermined.

Overall, special administration concerns merely the administration and distribution of client assets of the investment firm or investment bank. Despite the focus on financial contracts, there are no provisions that constrain the ability to enforce credit risk mitigation techniques beyond the typical restrictions under insolvency law. This suggests that the stringent measures which, under the Banking Act 2009, can restrict credit risk mitigation techniques are primarily concerned with the protection of confidence of depositors. It entails maintaining services that are essential to the continuation of services to depositors, but are not vital for financial stability. It supports the conjecture that intervention with contractual rights in financial contracts is not a consequence of the alleged increased risk.

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to be deposited with a third party. There are clear prescriptions as to the segregation of these assets, for instance under the Financial Conduct Authority's CASS Rules available at https://www.handbook.fca.org.uk/handbook/CASS/ <accessed 16 December 2016>. However, only an effective and pragmatic insolvency procedure or restructuring measure is required to maintain confidence that the security may be migrated with the covered financial transaction.

134 After the bar date, the administrator can distribute the assets based on a court-sanctioned listing of all the claims received from clients

135 See discussion on Pritchard Stockbrokers and Fyshe Horton Finney in Peter Bloxham, *Final review of the Investment Bank Special Administration Regulations 2011* (2014)

136 Eva Hüpkes, 'Too big to save -- towards a functional approach to resolving crises in global financial institutions' in Douglas Evanoff and George Kaufman (eds) *Resolving Large Bank Insolvencies* (World Scientific, 2005)

Proceedings	Credit institution with eligible depositors	Investment firm with eligible depositors	Credit institution without eligible depositors	Investment firm without eligible depositors
Conventional insolvency proceedings under the Insolvency Act 1986	Applicable	Applicable	Applicable	Applicable
Bank insolvency procedure under Part 2 of the Banking Act 2009 ("Bank Insolvency Procedure")	Applicable	Applicable		
Bank administration procedure under Part 3 of the Banking Act 2009 ("Bank Administration Procedure")	Applicable	Applicable	Applicable	Applicable
Special administration (bank insolvency) under the Investment Bank Special Administration Regulations 2011[1] ("Special Administration (Bank Insolvency)")		Applicable		
Special administration (bank administration) under the Investment Bank Special Administration Regulations 2011 ("Special Administration (Bank Administration)")		Applicable	Applicable	Applicable
Investment bank special administration under the Investment Bank Special Administration Regulations 2011 ("Investment Bank Special Administration")[2]				Applicable

Table 1: Insolvency proceedings applicable to financial institutions

Key: Eligible depositors means depositors as defined in section 93(3) of the Banking Act 2009, i.e. depositors who are eligible for compensation under the Financial Services Compensation Scheme established in Part 15 of the Financial Services and Markets Act 2000
Investment firm means an investment firm within the meaning of section 232 of the Banking Act 2009

[1] SI 2011/45
[2] SI 2011/245

5.4.4 Interaction between ordinary and modified insolvency

Modified insolvency resembles the ordinary regime. The main difference lies in the modified regime's primary objective which is to protect financial stability. Thus, though based on the Insolvency Act 1986 and the Insolvency Rules 1986, the predecessor of the Insolvency Rules 2016,[1] this reorientation has necessitated several consequential amendments. The reorientation of insolvency law shall primarily seek to protect the confidence of market participants, including depositors, and ensure the continuity of critical functions of the distressed financial institution. A crucial feature of a modified insolvency regime is therefore its ability to swiftly discern and transfer crucial parts of the financial institution to a transferee in the form of a third-party purchaser or bridge institution. Such a bridge institution shall act as a "warehouse" pending the eventual sale to a third-party purchaser or reintroduction to the market by way of an initial public offering. It should be pointed out that at times, transfer will be impossible. It requires that the insolvency proceedings applied against the residual institution can continue serving the third party or bridge institution.

Ordinary insolvency and administration proceedings in relation to unregulated companies can be initiated by any affected party by petitioning the court. In case of insolvency proceedings, this right of petition is reserved by the FCA, PRA and BoE. The BoE may seek to invoke the special provisions under the Financial Markets and Services Act 2000 in conjunction with ordinary insolvency law. Thus, while ordinary proceedings are managed by a liquidator or administrator, which can apply to the court for orders and directions, the special provisions provide special measures sanctioned by and subject to oversight by the courts.

Today, as will be examined more in detail below, in the event that insolvency proceedings under Part 2 or administration proceedings under Part 3 of the Banking Act are initiated, the objectives of the insolvency and administration procedures are aligned with those regarding resolution. Hence, the objectives of rehabilitation of the debtor and satisfaction of creditor claims are subordinated to financial stability. The latter means that after application the transfer, the residual institution shall support the transferee or continue the functions and services that are deemed essential to prevent the further deterioration of financial market stability. In addition, the UK has in place a special bank insolvency procedure ensuring that eligible depositors are paid promptly under the Financial Services Compensation Scheme.

The application of the modified insolvency proceedings is however not mandatory, which means that also conventional insolvency proceedings under the Insolvency Act 1986 can be initiated against the residual institution, notwithstanding concurrent application of the stabilisation options under the Banking Act 2009. Like in normal insolvency proceedings, petitioning the court will be required. In contrast, in modified insolvency proceedings the right to petition is reserved by the FCA, PRA and BoE.[2]

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1 Insolvency Rules 1986

2 See section 95 of the Banking Act 2009

5.5 Conclusion

The English response to the financial crisis was, in many respects, exemplary. Under the Banking (Special Provisions) Act 2008, the Treasury was empowered to issue transfer orders, which had the effect of varying the terms of the debt instrument and extinguishing share options. This right migrated into the Banking Act 2009. Surprisingly, these measures have been praised for constituting legal innovations under the BRRD. However, the BRRD measures did not need to be transposed as they were already contemplated in the Banking Act 2009. Moreover, the variation of the terms of debt instruments was also already provided for in the Banking Act 2009 (and its predecessor) in connection with transfers. Thus, bail-in to the extent that it applies to financial institutions is not a foreign element either. However, bail-in under the BRRD does not require application of other resolution measures. To a certain extent, it constitutes a novelty; however, the rationale is unclear. It is doubtful that exclusive exercise of the bail-in tool is sufficient to stabilise a distressed financial institution. Thus, the preferred measure is and remains transfer. This measure is supplemented by a suspension restricting the rights of trade creditors, including counterparties to financial contracts.

A particular feature of the special resolution regime is the insight that, after the transfer has been effected, the residual institution may be required to support the transferee, in the case the transferee is licensed to accept eligible deposits or return assets held on trust for investors. This support serves to contain distress. This reorientation of the primary objective of the modified insolvency regimes affects neither their prupose nor nature. In fact, it "is consistent with the priority of those claims and the existence of preferential claims in liquidation is a familiar feature of insolvency law".[3]

However, in relation to resolution, the Banking Act 2009 confers sweeping powers on the BoE. Application of the stabilisation options, in the form of either bail-in or transfer, which may also be combined, can have significant consequences for financial contracts. To facilitate the application of the stabilisation options and thus the realisation of the resolution strategy, the BoE has been given considerable discretion to interfere with contractual rights. Most notably, the ancillary powers expressly allow enforcement, suspension, prohibition, cancellation, etc. of credit risk mitigation arrangements. However, a guiding principle is that netting sets must be respected. Hence, the BoE has no authority to tear up arrangements or enforce transactions that are favourable to the debtor or institution under resolution. Accordingly, the European Banking Authority considerably limits the possibility to create sweep-up arrangements, whereby transactions that are included into netting sets for no commercial reason, with the sole aim of reducing the probability of becoming subject to a potential resolution action.[4]

Against this background, the BRRD and, by implication, the Banking Act 2009 contain vital safeguards that prevent the separation of close-out netting and collateral arrangements and preclude partial enforcement. However, it allows overriding the terms of the master agreement in case of a cancellation, write-down or conversion of claims. Moreover, it permits the disparate

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[3] Hamish Anderson, 'What is the purpose of insolvency proceedings?' (2016) 8 Journal of Business Law p. 670, p. 686

[4] See Kate Sumpter and Kelesi Blundell, 'Financial collateral and the BRRD: Change without consequence?' (2016) Journal of International Banking and Financial Law p. 81

treatment of creditors, depending on whether they have been transferred or have remained with the residual institution. Thus, counterparties may receive worse treatment in resolution despite the safeguards. Another guiding principle is that netting arrangements are to be observed and that it must be ensured that the close-out amount is always determined on a net basis. Consequently, creditors do not run the risk of excessive exposure. It implies, however, that the BoE or its appointed independent valuer must carry out complex valuations. Such valuations might not always be possible in accordance with the terms of the relevant master agreement. Therefore, the European Banking Authority has provided methodologies that may deviate from those set out in the master agreement. Safeguards, such as the no-creditor-worse-off principle, are expected to provide counterparties with sufficient certainty that the treatment will not be worse than in insolvency. However, given the intractable valuation methodologies, actual enforcement will represent a significant challenge.

Chapter 6
Implications for credit risk mitigation techniques

The previous chapters have stressed that, while close-out netting is integral to the operation of financial markets, at times, it is necessary to stay termination rights temporarily. This will ensure contractual stability which is vital for the implementation of resolution measures. However, financial contracts can also form sizeable obligations, which can be used to recapitalise the distressed financial institution or fund the resolution measures. This insight conflicts with the legislation promoting the use of close-out netting set out in Chapter 3. Thus, the measures discussed in Chapter 5 require adaptation of the whole legal framework relevant for close-out netting. The objective of this chapter is to consider the effects of the amendments to the laws governing credit risk mitigation techniques that followed the financial crisis of 2007. In particular, it explores the effects of the risk allocation that was previously regulated under the master agreements and has now been conferred on the Bank of England ("BoE"). Moreover, this chapter discusses proposed amendments to the BRRD, which allows reflecting on the importance of credit risk mitigation techniques and why further interference is highly problematic and unjustified. The chapter is structured as follows.

The first section postulates that the ability to interfere with financial contracts is evident from the consequential amendments to the legislation protecting credit risk mitigation techniques. Under EU law, the protection of credit risk mitigation remains a primary objective and can only be restricted in resolution. Intervention is strictly limited to resolution and subject to prior satisfaction of requirements that balance public and private interest, which motivates the need for intervention. It remains questionable, however, what the degree of intervention should be.

The second section discusses the issue of legal certainty and reasonable expectations in light of the resolution regime. It is claimed that significant powers have been conferred on resolution authorities. These powers were traditionally under the purview of the courts. The latter, however, cannot interfere in the resolution process. In this section it is argued that this shift from the judiciary to the administrative has negative consequences for legal certainty. This begs the question as to what the market can reasonably expect.

The third section reflects on the safeguards and protections benefiting counterparties that have been subjected to resolution. Due to the legislative history of the Banking Act 2009, there is a noticeable difference with other Member States. To safeguard netting arrangements, the UK legislator introduced special safeguarding orders. These orders are often perceived as netting legislation in practice. Therefore, their merits and shortcomings deserve special attention. Besides statutory protection, the resolution measures that will be applied by the BoE can represent another safeguard, which will be discussed below.

The fourth section develops the third. The BRRD and, by implication, the Banking Act 2009 stipulate that the treatment of creditors must be aligned or not be significantly worse than in a hypothetical insolvency scenario. The no-creditor-worse-off ("NCWO") principle militates against the latter risk. It

compares the outcome of the resolution with a counterfactual under insolvency law. This section argues, however, that the practicalities and level of abstraction make protection under the NCWO principle a non-viable and superficial solution.

The last section concludes. It recapitualises the foregoing discussion, which illustrate that resolution undermines contractual risk allocation. It argues that resolution authorities have become *de facto* risk managers, thus reversing a market-devised contractual mechanism that promotes certainty. It begs the question of the proportionality of the resolution measures.

6.1 Reform of EU "netting" legislation

In Chapter 3 we have seen that credit risk mitigation techniques embedded in collateral arranagement enjoy in principle beneficial treatment since these arrangements are carved out from the application of Member States' insolvency law measures that could preclude their enforceability. However, the financial crisis led to a globally sanctioned policy shift.[1] The BRRD and by implication the Banking Act 2009 expressly provide that under certain circumstances and subject to certain safeguards, contractual rights can be suspended, stayed or cancelled.[2] These extraordinary powers, these powers were deemed necessary. The netting legislation required adaptations to allow interference with financial contracts and close-out netting rights. This legislation can be divided into two separate categories, namely substantive law and conflict of laws.[3]

6.1.1 Substantive law

The BRRD has established a harmonised regime across the EEA by partially reconciling divergent measures of its member states with new objectives, principles and instruments. Evidently, it involves intervention with private rights and migration of measures relating to insolvency proceedings and restructuring measures. Effective implementation of the BRRD,[4] and by implication of the Banking Act 2009, requires, as will be seen below, reform of substantive laws. The interplay with insolvency law is most striking.[5] As explained above, the Banking Act 2009 established insolvency and administration proceedings pertinent to financial institutions.

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1 Financial Stability Board, Key Attributes of Effective Resolution Regime for Financial Institutions (October 2011 as amended in 2014), at paras 40-42; European Commission, Bank Recovery and Resolution Working Document (2011); and UNIDROIT, *Principles on the Operation of Close-out Netting Provisions. Explanation and Commentary* (2013), para 65-67. Principle 8 of the UNIDROIT paper states: "The principles are without prejudice to a stay or any other measure which the law of the implementing State, subjective to appropriate safeguards, may provide for in the context of resolution regimes for financial institutions"

2 For a broader policy shift towards a more granular analysis of the costs and benefits of financial regulation, see Mads Andenas Iris Chiu, 'Financial stability and legal integration in financial regulation' (2013) 38(3) European Law Review p. 335

3 Fransico Garcimartín, 'Derivatives in Cross-border Insolvency Proceedings' in Dennis Faber and Niels Vermunt (eds) *Bank Failure: Lessons from Lehman Brothers* (Oxford University Press 2017) para 14.36

4 See for the current development of the Financial Collateral Directive Thomas Keijser, 'Financial collateral arrangements in the European Union: Current state and the way forward' (2017) 22 Uniform Law Review p. 258. For a critique of the amendment to the Financial Collateral Directive see Kate Sumpter and Kelesi Blundell, 'Financial collateral and the BRRD: Change without consequence?' (2016) Journal of International Banking and Financial Law p. 81

5 For instance, Art 37(6) of the BRRD refers to the mandatory application of insolvency law to the residual institution after application of the transfer options

At this point it shall be reiterated that credit risk mitigation techniques are enforceable as a general principle of English law. Thus, although the Financial Collateral Directive was transposed through the Financial Collateral Arrangements (No 2) Regulations 2003 ("FCARs") in December 2003, it serves merely to affirm the enforceability of close-out netting and set-off rights that constitute qualifying financial collateral arrangements.[6] To reiterate, it stipulates that any insolvency proceeding or restructuring measure shall not hamper the enforceability of the credit risk mitigation technique. Consequently, it also prejudices the applicability of the Banking Act 2009.[7] Therefore, the Bank Recovery and Resolution (No 2) Order 2014 modified the FCARs. Pursuant to the amendments, the BoE is permitted to impose restrictions on (i) the enforcement of financial collateral arrangements, and (ii) the effect of a security financial collateral arrangement, close-out netting provision or set-off arrangement when exercising a stabilisation measure under Part I of the Banking Act 2009.

Moreover, the FCARs have been amended to prohibit that the commencement of recovery and resolution proceedings and any directly related measures[8] constitute an enforcement event. It reaffirms that collateral cannot be realised as a result of the Bank of England's intervention. It is predicated, however, on the continuation of substantive obligations. However, the amendments also clarify that "[n]othing in this regulation prevents the Bank of England imposing a restriction on the effect of a close-out netting provision in the exercise of its powers under Part 1 of the Banking Act 2009".[9]

The effect of the inserted provisions is twofold. First, it prevents that the initiation of recovery and resolution proceedings can result in termination, which would undermine the probability of success of such a measure. This restriction is general and permanent. The FSB Guidance provides that it shall be conditional on the continuation of substantive obligations. However, the BRRD recognises that, under certain circumstances, it may be preferable to also temporarily suspend substantive obligations. Although this was contrary to the FSB Guidance, the market conceded to this measure, under the precondition that temporary suspension may not exceed two business days. This minimises the risk that the financial contract and any collateral may become orphaned or fail to be commensurate with the hedgeable exposure or the exposure arising from the financial contract.

6.1.2 Conflict of laws

Most financial institutions operate a subsidiary and branch network across the Member States and even across regions.[10] As such, assets, liabilities and property are often held abroad and are subject

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6 An important aspect of the FCARs is that they abolished formalities, since because failure to comply with these formalities on technical grounds often resulted in unenforceability of the collateral arrangement, see section 3.2

7 Fransico Garcimartín, 'Resolution Tools and Derivatives' in Matthias Hantjes and Bob Wessels (eds) *Bank Recovery and Resolution: A Conference Book* (Elven International Publishing, 2014) p. 179, pp. 187-190 and Matthias Lehmann, 'La Resolution et le droit international privé' (2014) 4 Revue de Droit bancaire et financier

8 Section 48Z of the Banking Act 2009

9 Regulation 12(5) of the FCARs

10 This conflict of laws analysis will concentrate on the European regime. At present, there are no meaningful international treaties that establish a conflict of laws regime promoting recognition of the home authority's resolution action by a third-state host authority. Cross-border insolvencies have been facilitated by insolvency protocols, mostly between the United Kingdom and the United States. These protocols harmonise proceedings. They are quite broadly phrased and contemplate cooperation and exchange of information, and not execution of insolvency measures, see the Maxwell Communications

to the laws of the respective jurisdiction. Against this background, it is evident that the effective implementation of stabilisation measures requires a cross-border reach. This has been a guiding policy reason for the introduction of the BRRD. Ostensibly, harmonisation of resolution measures in all EEA member states can achieve not only recognition but also active support from and coordination with host authorities.[11]

As mentioned earlier, regulations 34 and 36 of the Credit Institutions (Reorganisation and Winding up) Regulations 2004 stipulate that financial contracts shall be exclusively governed by the laws elected by the parties (*lex contractus*). In effect, these regulations bar authorities from imposing requirements alien to the contractually elected law, unless the provisions offend against the *ordre public*.[12] Traditionally, financial stability did not constitute such ground. However, this has been partially altered, as will be seen below.

Regarding close-out netting, it was previously mentioned that the Credit Institutions (Reorganisation and Winding up) Regulations 2004 provide that such arrangements shall take effect in accordance with the laws chosen by the parties.[13] Although unclear,[14] this seems to suggest that parties are allowed to pre-empt becoming subject to a particular regime or measure by electing a governing law that does not provide the same powers. As a clarification, the relevant provision now stipulates that

> (1) The effects of a relevant reorganisation or a relevant winding up on a netting agreement shall be determined in accordance with the law applicable to that agreement. (2) Nothing in paragraph (1) affects the application of—(a) section 48Z of the Banking Act 2009 9; (b) section 70C of the Banking Act 2009 10; (c) Articles 68 and 71 of the recovery and resolution directive or the law of any EEA State (other than the United Kingdom) transposing these provisions; or (d) any instrument made under the provisions referred to in sub-paragraph (a) or (b).[15]

This means that although there is still uncertainty concerning insolvency proceedings, it is certain that resolution measures alien to the governing law will override conflicting measures or will be

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Corporation case of 1991 (see Charles Zhen Qu, 'Sanctioning schemes of arrangement: the need for granting the court a curative power' (2016) 1 Journal of Business Law p. 13 and *Re Maxwell Communications Corp Plc (No.2)* [1993] 1 W.L.R. 1402). However, given the expected complexity and intractable areas relating to financial institution insolvency, not least due to the volume and size of the claims, Linklaters LLP, acting as administrator of Lehman Brothers, did not sign the Lehman protocol. In a note addressed to Lehman's creditors, of March 2009, Linklaters LLP argued that it would not be in the best interests of the English Lehman Brothers entity. Hence, this problem of coordination and cooperation is not solved with a conflict of laws approach but rather by requiring contractual recognition, see section 5.3. Otherwise financial institutions could easily circumvent the BRRD by transferring assets or property to a subsidiary located in a third state or by concluding contracts through such a subsidiary pursuant to the laws of a third state. See Financial Stability Board, *Principles for Cross-border Effectiveness of Resolution Actions* (November 2015) and Matthias Lehmann, 'Bail-in and private international law: how to make bank resolution measures effective across borders' (2017) 66(1) International & Comparative Law Quarterly p. 107

11 See section 4.4.3

12 See Miguel Virgós and Francisco Garcimartín, 'Conditional conflict of laws rules: A proposal in the area of bank resolution and netting in cross-border scenarios' (2012) 9(2) International Corporate Rescue p.91, Jens-Hinrich Binder, 'Cross-border coordination of bank resolution in the EU: All problems resolved?' (2016) 13(4) European Company and Financial Law Review p. 575; see, in the general context of non-derogable state law, Rajesh Pillai and Hannah Glover, 'ISDA Master Agreement: Party choice versus non-derogable state law' (2016) Journal of International Banking and Financial Law p. 401

13 Bank for International Settlements, *Basel Committee on Banking Supervision: Report and recommendations of the Cross-border Bank Resolution Group* (March 2010) pp. 40 to 41. See also Fransico Garcimartín, 'Derivatives in Cross-border Insolvency Proceedings' in Dennis Faber and Niels Vermunt (eds) *Bank Failure: Lessons from Lehman Brothers* (Oxford University Press 2017) para 14.53

14 The relevant provision of the Reorganisation and Winding up of Credit Institutions Directive refers to "the law of the contract". It is unclear whether this also includes insolvency law

15 Regulation 34 of the Credit Institutions (Reorganisation and Winding up) Regulations 2004

imported notwithstanding the absence of similar measures under local law.[16] The provisions protecting repurchase agreements have been likewise amended:

> — Repurchase agreements (1) Subject to regulation 33, the effects of a relevant reorganisation or a relevant winding up on a repurchase agreement shall be determined in accordance with the law applicable to that agreement. (2) Nothing in paragraph (1) affects the application of— (a) section 48Z of the Banking Act 2009 9; (b) section 70C of the Banking Act 2009 10; (c) Articles 68 and 71 of the recovery and resolution directive or the law of any EEA State (other than the United Kingdom) transposing these provisions; or (d) any instrument made under the provisions referred to in sub-paragraph (a) or (b).[17]

Conflict of law provisions contain restrictions regarding arrangements that are contrary to mandatory or imperative provisions of domestic law or *ordre public*. Arguably, the text of the BRRD and by implication of the Banking Act 2009 affects both, since the public interest is affected. It should be recalled that resolution is predicated on the essential need to maintain systemic stability, and that invoking its measures will be conditional on the satisfaction of the precondition of necessity and on the absence of a suitable alternative, and should be in the public interest. Hence, the existence of the BRRD provides certainty as to when resolution may be expected, which measures can be applied against the counterparties and what the potential implications for counterparties may be.

Uncertainty as to the applicable insolvency regime may present challenges for resolution. What insolvency proceedings should be instituted to create a counterfactual is unclear. The paucity of relevant case law and the absence of relevant academic literature do not permit to predict with certainty how resolution authorities will decide. Overall, however, close-out netting and collateral provisions may not be overridden in their entirety. Hence, the question of treatment arises only in case of shortfalls of collateral, requiring the non-defaulting counterparty to prove its debt. Only in such cases will the ranking of debts be essential, thus complicating litigation inherent in the no-creditor-worse-off principle, as mentioned above.[18]

6.1.3 Emergence of European restrictions of *ipso facto* clauses

The rules of the Banking Act 2009 resemble restrictions of *ipso facto* clauses in relation to European financial institutions, i.e. the general prohibition to cancel or terminate contracts due to impending or actual insolvency.[19] It should be noted that English law "has traditionally remained faithful to the freedom of contract principle".[20] Moreover, it cannot be suggested that this is a "contamination" of European law that has been inadvertently inserted. Such conjecture would contradict the *acquis* relating to the support of financial contracts and close-out netting. As seen above, it is especially the

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16 Regulation 5 of the Credit Institutions (Reorganisation and Winding up) Regulations 2004. No doubt this will present a considerable challenge if there is no analogous proceeding. In relation to set-off and close-out netting, regarding which application is highly fact-specific, it is uncertain to what extent close-out netting provisions can be taken into consideration. Regulation 36 may, however, reaffirm the ability to exercise close-out netting provisions and may be applied by analogy to Regulation 34 as this would be within the policy rationale of the regulations

17 Regulation 36 of the Credit Institutions (Reorganisation and Winding up) Regulations 2004

18 Hodge Malek QC and Sarah Bousfield, 'Bad banks and the "No Creditor Worse Off" compensation scheme' (2016) Journal of International Banking and Financial Law p. 339

19 See section 2.3

20 Ravi Suchak, 'Corporate rescue proceedings and the enforcement of *ipso facto* termination clauses: A comparison of the English and US approaches' (2011) 8(2) International Corporate Rescue p. 131, p. 134

Financial Collateral Directive that carves out close-out netting arrangements from the purview of insolvency law if a financial institution is involved.[21]

Thus, the prohibition of *ipso facto* clauses does not constitute a normative rule. Neither the BRRD nor the Banking Act 2009 contain a general prohibition. In fact, *ipso facto* clauses remain permissible unless expressly restricted for a limited duration or permanentely if related to resolution. It is therefore not necessary for the arrangements or contracts to satisfy narrow preconditions in order to benefit from a "safe harbour", as is the approach in the US.[22] Moreover, the restrictions are limited and targeted, and seek to avoid undue detriment to the debtor and the general body of creditors. This is to some extent inconsistent with the rescue culture introduced by the Banking Act 2009. The limited intervention balances contractual sanctity and financial stability. However, even before the introduction of the Banking Act 2009, section 112 of the Financial Markets and Services Act 2000 already provided a court-administered restriction of termination and enforcement rights. Thus, the regime is rather a recognition that this intervention in party autonomy is merely ancillary to fulfilling the objective of stabilising the distressed financial institution. It is essential is that the BoE encounters contractual stability when executing the resolution measures. Moreover, executory contracts shall be continued if the reason for the default can be cured. Since financial stability is of no consideration in insolvency, contractual stability is limited to a few agreements, such as utility contracts.[23] These contracts are essential for the administration and orderly wind-up

It may be argued that financial contracts constitute an essential utility for financial institutions; early termination of financial contracts adversely affect the viability of financial institutions. Restricting general permission is thus still and foremost guided by the need to prevent that contractual arrangements contravene statute, i.e. undermine the objective of financial stability. In other words, the primacy of statute prevails.[24] Safeguards were concurrently introduced to operate efficiently within the current regulatory framework. Their absence would have undermined the benefits of close-out netting. The safeguards underpin the validity and enforceability of close-out netting arrangements.

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21 See section 3.2

22 Ravi Suchak, 'Corporate rescue proceedings and the enforcement of *ipso facto* termination clauses: A comparison of the English and US approaches' (2011) 8(2) International Corporate Rescue p. 131, p. 134

23 Section 233 of the Insolvency Act 1986. See also Richard Tett, 'Administration falls short: The need for contractual stability and an executory contract regime' (2012) 9(3) International Corporate Rescue p. 167

24 In fact, even prior to the financial crisis and the Banking Act 2009, any arrangement that was found to undermine the effect of the Insolvency Act 1986 was rendered void, see section 2.4.3

6.2 Reshaping legal certainty and reasonable expectations

Joanne Braithwaite and David Murphy defined legal certainty as being the outcome "broadly known and expected by market participants".[25] Legal certainty serves a fundamental purpose. In the words of Fenwick and Wrbka:[26]

> In the context of legal modernity, the principle of legal certainty – the idea that the law must be sufficiently clear to provide those subject to legal norms with the means to *regulate their own conduct* and to protect against the arbitrary exercise of public power – has operated as a foundational rule of law value. As such, legal certainty has played a *vital role in determining the space of individual freedom and the scope of state power*. In this way, the ideal of legal certainty has been central in stabilizing normative expectations and in providing a framework for social interaction, as well as defining individual freedom and political power… (*emphasis added*)

Conflicts between reasonable expectations and public policy are inevitable, in particular in the context of financial markets.[27] These conflicts allow for occasional departures as complete certainty is an elusive goal. As Lord Justice Briggs said, legal certainty is a *desideratum* rather than a principle of English law.[28] It imposes fundamental constraints. On balance, the objective is nonetheless to maintain legal certainty. As discussed above, master agreements establish such certainty as they allocate risk by containing crisis management mechanisms in order to address default on the part of the counterparty.[29] This is predicated on the sanctity of "commercial legal certainty", which is a unitary concept.[30] Courts "spare neither trouble nor expense" to reaffirm it. For instance, Lord Bingham criticised the reasoning of his fellow judges as undermining "the quality of certainty which is a traditional strength and major selling point of English commercial law".[31] Departing from established precedents,[32] inability to ascertain the consequences of some wrong, or contravening an established line of reasoning may give rise to uncertainty.[33]

Whether legal certainty qualifies as a general principle under English law and its application extends to the BoE is therefore disputable. This insight challenges the assumption that the BoE will abide by

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25 Joanne Braithwaite and David Murphy, 'Got to be certain: The legal framework for CCP default management processes' (2016) Bank of England Financial Stability Paper No 37; it follows the rationale that 'It is of the utmost importance in commercial transactions that, if any particular event occurs which may affect the parties' respective rights under a commercial contract, they should know where they stand', as established in *Scandinavian Trading Tanker Co AB v Flota Petrolera Ecuatoriana* [1983] QB 529 per Goff LJ.

26 Mark Fenwick and Stefan Wrbka, 'The shifting meaning of legal certainty' in Mark Fenwick and Stefan Wrbka (eds) *Legal certainty in a contemporary context* (Springer 2016) p. 1

27 See Mark Fenwick and Stefan Wrbka, 'The shifting meaning of legal certainty' in Mark Fenwick and Stefan Wrbka (eds) *Legal certainty in a contemporary context* (Springer 2016) p. 2

28 Lord Justice Briggs, 'Legal uncertainty in the financial markets: how can the courts assist?' (2017) 32(2) Journal of International Banking and Financial Law p. 63

29 It should be stressed that not only the private sector but also public authorities require this certainty in their market operations, see International Monetary Fund, *The Quest for Lasting Stability* (2012) Global Financial Stability Report: 81

30 Lord Justice Briggs, 'Legal uncertainty in the financial markets: how can the courts assist?' (2017) 32(2) Journal of International Banking and Financial Law p. 63

31 *Golden Strait Corp v Nippon Yusen Kubishika Kaisha* [2007] UKHL 12 para 368

32 Ibid

33 Lord Justice Briggs, 'Legal uncertainty in the financial markets: how can the courts assist?' (2017) 32(2) Journal of International Banking and Financial Law p. 63

it – unless the Banking Act 2009 or the Code of Practice provide otherwise. Overall, departure from strict certainty can be justified if this serves overriding public policy goals, such as financial stability.[34]

Insolvency proceedings ensure predictability regarding the creditors' treatment if the debtor experiences distress threatening its viability. It conflicts with the significant discretion arising from the discretion of resolution authorities under the resolution regimes. In the context of financial contracts, the primary concerns is the disorderly termination in anticipation of the imminent or actual default.[35] Financial market participants, such as credit institutions and investment firms, have traditionally been accorded special protection from insolvency law that may restrict the ability to enforce credit risk mitigation techniques since these mechanisms have been considered vital to financial stability. The new stabilisation powers provide means to rescue distressed financial institutions in part or in their entirety. However, this is subject to the precondition that the stabilisation measure proves effective. Additionally, due to the absence of procedural specification of unclear safeguards, there is uncertainty about the actual treatment.

6.2.1 Judicial regime

In insolvency or reorganisation proceedings, courts take on a crucial role. In the case of ordinary companies the right to commence insolvency proceedings under the Insolvency Act 1986 is reserved for the court; in case of financial institutions, insolvency proceedings are petitioned by the PRA, FCA, Treasury or BoE exclusively, and are opened by the court. Though the court's involvement forms a negligible part of the insolvency or administration procedure, judicial review will seek to ascertain and remedy any administrative failure.[36] Similarly, it may provide guidance to the administrator.[37] Court remedies include the right of injunction and express permission, which allows overriding the administrative measure.[38] However, the award of such injunction and permission is subject to substantial uncertainty, as is the outcome of the judicial review. This inherently begs the question of why a power apparently more apt to remain in the judicial realm was delegated to administrative bodies. It shall be noted that this delegation was not inadvertent. In case of resolution, the right to commence proceedings lies with the BoE as resolution authority and the court has no approval, appealing or suspensory authority.[39]

6.2.1.1 Courts on insolvency

An administrator or liquidator may apply to the courts for directions pursuant to the Insolvency Rules 2016. The application for directions can be traced back to directions associated with trusts in the 19th century. However, modern directions and procedures have proved proficient in addressing

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34 See Pablo Martin Rodriguez, 'A missing piece of European emergency law: Legal certainty and individuals' expectations in the EU response to the crisis' (2016) 12(2) European Constitutional Law Review p. 265

35 John Armour, 'The law and economics of corporate insolvency: A review' (2001) ESRC Centre for Business Research Woking Paper N 197

36 Para 74 of Schedule B1 to the Insolvency Act 1986; see also Michael Schillig, *Resolution and Insolvency of Bank and Financial Institutions* (Oxford University Press 2016) p. 109

37 Para 63 of Schedule B1 to the Insolvency Act 1986

38 Para 43 of Schedule B1 to the Insolvency Act 1986

39 The court can appeal in relation to crisis prevention measures. In relation to crisis management measures, a court appeal only has an *ex post* compensatory effect. In other words, the resolution measure is unhampered by any appeal

present challenges in a consistent way.[40] This is due the courts' pragmatic and commercial orientation. Courts reconcile and prioritise conflicting matters between different parties that are affected and are otherwise involved in insolvency. The court acts, as it were, as "arbitrator" since it is inherently an unaffected party, which must first and foremost achieve the objectives set out in insolvency law, while being able to consider the position of all those involved. In contrast, the BoE takes a different position and approach. Interests of creditors are, at first instance, subordinated to financial stability and the viability of the financial institution. There is no provision ensuring efficient communication between affected creditors and the BoE. In case of bank insolvency and bank administration, financial stability explicitly takes precedence over creditors' interest.

6.2.1.2 Courts and the financial crisis

Due to Lehman Brothers' prominent presence in England, as a major global trading entity, its collapse resulted in an unprecedented amount of litigation. Previous litigation examined amongst others the default management under the master agreements concerning buy-side institutions such as brokers and insurance companies; however, the subject of the trail was never such a large-scale sell-side investment firms as Lehman.[41] Thus, courts with extensive experience in respect of the construction of terms of master agreements, had to consider surrounding issues associated with the scale of Lehman. This involved consideration of client asset return and technical obstacles to the appropriate enforcement of the default management measures under the master agreements. Moreover, it was previously presumed that bank groups share a common interest. Ensuing litigation illustrated that all group entities act in their own interest – even prejudicing a fellow group entity.

However, this and subsequent cases[42] showed the "flexibility of the common law of trusts in the face of unprecedented challenges".[43] Due to the paucity of relevant authority, there was uncertainty regarding the construction of certain terms of the master agreement. In particular, the court disagreed with the US court presiding over same matters – thereby underpinning the sanctity of the ISDA Master Agreements.[44] Although just referring to a trust analysis, it may be submitted that English courts are proficient in maintaining certainty in their commercial and pragmatic approach. As Lord Justice Briggs states, "it is central to the attractiveness of the ISDA contracts for which English law is chosen that its meaning should be clear, commercially sensible, and predictable and that the English courts should be able to iron out any ambiguities both speedily and in a consistent

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40 The Right Honourable Lord Justice Briggs, 'How has English law coped with the Lehman collapse' in Dennis Faber and Niels Vermunt (eds) *Bank Failure: Lessons from Lehman Brothers* (Oxford University Press 2017) para 6.57

41 Ibid para 6.01

42 For instance, *Re Lehman Bothers International (Europe) (in administation)* [2012] EWHC 2997 (Ch)

43 The Right Honourable Lord Justice Briggs, 'How has English law coped with the Lehman collapse' in Dennis Faber and Niels Vermunt (eds) *Bank Failure: Lessons from Lehman Brothers* (Oxford University Press 2017) para 6.20

44 See section 2(a)(iii) litigation in Catherine Gurney, 'Calling time on section 2(a)(iii) of the ISDA Master Agreement: ISDA publishes an amendment' (2014) 29(8) Journal of International Banking Law and Regulation p. 520; Ed Nalbantian, Liz Saxton and Harriet Territt, 'section 2(a)(iii) of the ISDA Master Agreement: a brief retrospective' (2014) 29(3) Journal of International Banking Law and Regulation p. 195; Carl Baker, 'Rethinking the ISDA flawed asset' (2012) 27(6) 27 Journal of Banking Law and Regulation p. 250; and Timothy Cleary, 'Financial derivatives and the anti-deprivation principle' (2011) 26(8) Journal of International Banking Law and Regulation p. 379

way".[45] Although this is a self-imposed requirement, it is echoed by residing commercial and insolvency judges.

6.2.1.3 Criticism

Although courts have the benefit of insolvency-related experience, they are not apt to resolve financial institutions. The resolution of such institutions not merely requires insolvency expertise. For instance, a lesson learnt from the financial crisis is that planning is pivotal to ensure financial stability. While the BRRD contains provisions on the preparations, early intervention and resolution, the Banking Act 2009 addresses only resolution.[46] In England, these elements form part of, amongst others, the Financial Conduct Authority's and Prudential Regulatory Authority's Handbooks. Most importantly for the present purpose, the resolution authority must prepare a resolution plan on the basis of a recovery plan prepared by the competent authority in conjunction with the financial institution.[47]

In contrast to courts, the BoE is proficient in the assessment of the financial institution's relative strength, market position and prospect of continuing to operate, while observing potential ramifications and knock-on effects for the market. Courts cannot be reasonably expected to have the ability to rehabilitate a financial institution or its systemically relevant parts, without inadvertently threatening financial stability. In essence, the BoE is less concerned with productive assets that keep their intrinsic value irrespective of the market environment, but must take a comprehensive view whereby its actions are timed in accordance with market volatility. Courts cannot undertake this exercise.

Not least significant is the coordination with foreign authorities. Finance is inherently international, and the operations of financial institutions are cross-jurisdictional. Considering the need to plan with authorities in other jurisdictions and to operate together in the event of an insolvency, it is evident that the courts cannot be expected to assert jurisdiction. International comity and recognition of judgments, via statute such as the Recast Brussels Regulation[48] or common law, are subject to narrow "pathways" and grounds that must be met to assist foreign courts. Apart from those jurisdictions that have implemented the Recast Brussels Regulation, recognition may present immensurable complications and be ill-suited given the time-sensitivity. In addition, even where the recognition regulation has been implemented, it is subject to various exemptions which merit careful examination.

Overall, courts are not adequately positioned to manage resolution proceedings. However, for the special proceedings to be instigated their expertise will be required. The rules governing Bank liquidation initiated by court order have been amended to reflect the need for prompt action. The

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45 The Right Honourable Lord Justice Briggs, 'How has English law coped with the Lehman collapse' in Dennis Faber and Niels Vermunt (eds) *Bank Failure: Lessons from Lehman Brothers* (Oxford University Press 2017) para 6.33

46 Titles II, III and IV of the BRRD, respectively

47 Regulation (EU) 2016/1075; see also Chen Chen Hu, 'The bank recovery framework under the BRRD: an analysis' (2015) 26(10) International Company and Commercial Law Review p. 328, p. 333; see for the English approach Bob Penn, Knox McIlwain and Alex Forzani (2017) 30(68) International Financial Law Review p. 60

48 Regulation 1215/2012

amendment provides that court proceedings must be initiated without undue delay.[49] A court entertaining the proceedings must establish a subdivision specialised in financial institutions, which would be regulated in ways and be subject to principles that differ extensively from those governing courts.

6.2.2 Administrative regime

The experiences of the financial crisis of 2007 explain the abovementioned development. First, the Prudential Regulatory Authority and BoE have arguably greater expertise in assessing and managing distressed financial institutions. Second, forgoing the intermediate step of requiring court approval expedites the resolution. During the financial crisis of 2007, it became agonisingly evident that prompt intervention was crucial to averting systemic risk.[50] Third, in times of crisis, courts are overburdened and lack the resources to adequately address the critical problems they face. Moreover, they are not mandated to safeguard financial stability, and consequently ill-suited to assume this role.

Essentially, the aforementioned crisis management framework must be invoked before the commencement of ordinary insolvency proceedings. Recovery and resolution planning militate against uncertainty in repsect of measures that will be initiated to manage the failing financial institutions. It follows the Roman adage: "*Si vis pacem, para bellum*".[51] It is elusive to anticipate all possible eventualities. The origins of the distress, i.e. either intrinsic or extrinsic, and the structure and size of the distressed institution as well as the general market conditions determine the possibility to realise the envisaged measures. Flexibility in the response is therefore critical. At the same time, it is evident that the measures should, to an extent, be pre-emptive, i.e. averting further deterioration. In light of the inability to anticipate, the measures may prove excessive.

The English approach, however, is cognisant of this problem and seeks to limit the BoE's intervention to a minimum. In particular, the intervention shall be "justified and proportionate to the public interest".[52] Moreover, "appropriate safeguards [shall] provide a sufficient level of certainty and clarity for those whose rights may be affected".[53] Due to the novelty of stabilisation measures, especially bail-in, confidence will be undermined.[54] At this junction, it should also be recalled that resolution needs to observe the no-creditor-worse-off than in a hypothetical insolvency principle. This objective and principle also imply that intervention must be restricted to the most critical scenarios. Nevertheless, resolution is likely to be instigated in the context of financial institutions with sizeable financial contract operations. Although the BoE spares no effort to be transparent and to prepare

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49 This is not of relevance in case of bank administration, which is merely ancillary to the resolution strategy. Hence, measures will be taken to contain the crisis under Part 1 of the Banking Act 2009; administration under Part 3 of the Banking Act 2009 is instigated once transfer orders have been published or effected – i.e. when the crisis is contained.

50 Section 4.3.2

51 If you want peace, prepare for war

52 Explanatory Memorandum to the Bank Recovery and Resolution (No 2) Order 2014 (2014 No 3348) para 7.6

53 Ibid

54 Kern Alexander, 'Bail-in: a regulatory critique' (2017) 10(1) Corporate Rescue and Insolvency 9, and Kern Alexander, 'Bail-in: a regulatory critique' (2017) 32(1) Journal of International Banking and Financial Law 28

financial markets for its approach, the following remains an uncertainty which can defeat the purpose of the resolution framework.

The framework suffers from the absence of clear accountability and sufficient certainty relating to remedial measures. Other than in judicial proceedings, there is no multitude of layers that can provide temporary relief such as injunctions. Most noticeable is, however, the obvious inability to challenge the measures and, if successful, inability to obtain remedies. Although the Banking Act 2009 provides for compensation in case of disproportionate loss resulting from intervention, invoking the relevant provision can be a significant obstacle. It should not be forgotten that the challenge and proof must come from the affected creditor or group of creditors. In the context of financial contracts, the affected creditors are most likely other financial institutions subject to the BoE's supervision. To prove the claim, the affected creditor will need to identify the alleged transgressions on pain of endangering the valuable relationship with the BoE. This will represent a significant consideration which can thwart the instigation of remedial proceedings.

6.2.2.1 The Bank of England

Today's role of the BoE in safeguarding financial stability is undisputed, in particular due to the powers conferred by the Banking Act 2009. It is therefore germane to assess the development and actual powers of the Bank, which may interfere with private rights.

(a) Development of powers

The above discussion suggests that the BoE has emerged as a "very different" institution.[55] Its role in financial supervision is, however, no novelty. Before 1997, the English regulatory landscape was characterised by a plethora of regulators, both self-regulatory bodies and public institutions.[56] Amongst these institutions was the BoE, as supervisor of financial institutions. Under the Financial Services and Markets Act 2000 ("FSMA") the different roles of these bodies were combined and migrated to the predecessor of the Financial Conduct Authority, i.e. the Financial Services Authority. The transfer of responsibility was arguably predicated on the failure of the BoE to adequately supervise the Bank of Credit and Commerce International. After the latter's failure, a dispute ensued which lasted 13 years. Although the BoE was proven not to have acted inappropriately, its image as supervisor was considerably tainted.[57]

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55 Benjamin Geva, 'Systemic risk and financial stability: the evolving role of the central bank' (2013) 28(10) Journal of International Banking Law and Regulation p. 403 and Graeme Baber, 'A new approach to financial regulation: a step in the correct direction?' (2012) 33(1) Company Lawyer p. 3

56 Graham Nicholson and Michael Salib, 'The regulatory powers and purview of the Bank of England: Pre- and post-crisis' (2013) 28(10) Journal of International Banking and Financial Law p. 636

57 Philip Rawlings, 'Reform of bank Regulation in the United Kingdom: the opening salvo' (2010) 25(10) Journal of International Banking Law and Regulation p. 522, p. 526

This system was not perfect.[58] The reversion of the development of supervision powers by virtue of the Financial Services Act 2012 was precipitated by the financial crisis.[59] This amplification of powers was significantly supported by the earlier independence conferred on the BoE by virtue of the Bank of England Act 1998.[60] The latter's objective was to ensure that monetary policy is free from political interference.[61] The legislator thereby sought to reinforce the credibility of the Bank's decision making process.[62] The BoE enjoys the immunity of a sovereign.[63] However, it cannot be inferred that this immunity absolves it from accountability.[64] The accountability depends on whether the Bank acts proportionate in pursuing its objectives. The financial stability objective is difficult to measure. It is presumably easier to establish whether the BoE has achieved its monetary policy objective. It is even possible to measure the extent to which the policy objective has been reached. In contrast, macro-prudential supervision is inherently a "binary event", i.e. the presence or absence of a crisis.[65] Due to the uncertainty, macro-prudential regulation requires the simulation of counterfactuals. It substantiates, in principle, the likely costs and risks of interference or of no interference. Thus, although there has been a shift from a micro-prudential to a macro-prudential notion, the BoE pursues first and foremost the objectives and preconditions of the Banking Act 2009 which justify intervention.

(b) Powers and discretion

The relevant powers and discretion are formed by various laws, including the Banking Act 2009, the Financial Markets and Services Act 2000, secondary legislation and regulatory technical standards prepared by the European Banking Authority. Given the purpose of the Banking Act 2009, it may be inferred that it is to take precedence, in particular its objectives, in guiding any resolution measure. Its objectives are (i) to protect and enhance the financial system of the United Kingdom, (ii) to protect and enhance public confidence in the stability of the banking system of the United Kingdom, (iii) to protect depositors, (iv) to protect public funds, and (v) to avoid interfering with property rights in

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58 The FSA's approach to supervision was subject to considerable challenge. Its primary statutory objective was not the promotion of financial stability but innovation and promoting the UK's competitiveness, see Saptarshi Ghosh and Swetketu Patnaik, 'The Independent Banking Commission (Vickers) report: squaring the circle?' (2012) 54(2) International Journal of Law & Management p. 141. In practice, its "light touch approach to regulation" emphasised the conduct-of-business aspect and seemed to disregard prudential regulation, see Financial Services Authority, *Turner Review: A Regulatory Response to the Global Banking Crisis* (March 2009), p. 87

59 The importance of the Financial Services Act 2012 for the currently regulatory framework cannot be overstressed. For instance, it abolished the FSA, established the FCA and conferred supervisory powers on the Prudential Regulatory Authority, which is a body of the Bank of England. In effect, it established the current twin-peak model between conduct and prudential regulator, see Andreas Kokkinis, 'The Financial Services Act 2012: the recent overhaul of the UK's financial regulatory structure' (2013) 24(9) International Company and Commercial Law Review p. 325, Iain MacNeil, 'The trajectory of regulatory reform in the UK in the wake of the financial crisis' (2010) 11(4) European Business Organization Law Review p. 483 and James Perry, Rob Moulton, Glynn Barwick, Richard Small, Jake Green, Nicola Kay, 'The new UK regulatory landscape' (2011) 84(3) Compliance Officer Bulletin p. 1. The bank resolution powers were conferred on the Bank of England by the Banking Act 2009.

60 See Peter Burnham, 'The alternative externalisation strategy, operational independence and the Bank of England' (2017) 70(1) Parliamentary Affairs p. 173

61 Responsibility for monetary and financial stability is shared between the Bank of England, the Treasury and the Financial Conduct Authority, in accordance with a non-statutory Memorandum of Understanding

62 The primary objective of the Bank of England is to formulate monetary policy with the ultimate goal of maintaining price stability at 2 per cent

63 Section 244 of the Banking Act 2009; see Iain MacNeil, 'The trajectory of regulatory reform in the UK in the wake of the financial crisis' (2010) 11(4) European Business Organization Law Review p. 483, p. 488

64 Section 87 of the Financial Services Act 2012

65 Xavier Freixas, Luc Laeven and José-Luis Peydró, *Systemic risk, crises, and macro-prudential Regulation* (MIT Press, 2015) p. 346

contravention of a Convention right within the meaning of the Human Rights Act 1998. On balance, the measures need to be proportionate to the objective of protecting the public interest.[66] Thus, interference is limited to the extent that it implicates Convention rights, such as "every natural or legal person [shall be] entitled to the peaceful enjoyment of his possessions. No one shall be deprived of his possessions except in the public interest and subject to the conditions provided for by law and by the general principles of international law."[67]

The Convention continues: "The preceding provisions shall not, however, in any way impair the right of a State to enforce such laws as it deems necessary to control the use of property in accordance with the general interest or to secure the payment of taxes or other contributions or penalties". This sentence suggests that interference may be enforceable subject to narrow exceptions.[68] The difficulty lies in the construction of these narrow exceptions. However, given the discretion of the resolution authority, it is impossible to predict the implications of resolution measures for financial contracts. For instance, it is inevitable that financial contracts will receive differing treatment, depending on whether they were subject of the transfer order or have remained at the residual institution. It is germane to explore the extent of the discretion and the remedial effects of the safeguard orders to assess the risk or potential losses.

(c) Problem

Unsurprisingly, after the financial crisis of 2007, the widely shared consensus was that reform was needed to avert a new crisis. Kern Alexander argues that "[r]egulators, who are themselves usually subject to political short-termism, typically respond by focusing on *ex ante* preventative regulation, or at least regulation aimed at preventing the next financial crisis".[69] He continues to criticise this approach since it is flawed *ab initio.* A preventive regime cannot be sufficiently comprehensive since the causes of crises are hard if not even impossible to predict. While panic marks the onset of crises, the source is mostly discovered in its aftermath. This explains why reform is likely to introduce ad hoc measures, producing a patchwork of "unsystematic ideas".[70] In general, although being a sensible measure, the interaction with other regulation or resolution measures may inadvertently cause the opposite effect.[71]

This ad hoc approach results in either overly specific regulatory proposals without practical guidance as to their application or use, or overly broad propositions that provide no concrete regulatory guidance. As an example of overly specific regulatory measures, the "emergent macroprudential 'toolkit' as currently constituted" seeks to limit the growth of leverage across financial sectors, to enhance capital buffer requirements, to set minimum liquidity requirements and limits on maturity

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66 Para 3.15 of the Code of Practice

67 Art 1(1) of Protocol I to the European Convention of Human Rights and Art 17 of the Charter of Fundamental Rights of the European Union 2000

68 Art 1(2) of Protocol I to the European Convention of Human Rights and Art 17 of the Charter of Fundamental Rights of the European Union 2000

69 Kern Alexander, 'Bail-in: a regulatory critique' (2017) 10(1) Corporate Rescue and Insolvency p. 9

70 Kern Alexander and Steven Schwarcz (2016), 'The Macroprudential Quandary: Unsystematic Efforts to Reform Financial Regulation' in Ross Buckley, Emilios Avgouleas and Douglas Arner (eds) *Reconceptualising Global Finance and its Regulation* (Cambridge University Press 2016)

71 See Emilios Avgouleas, Charles Goodhart, 'Critical Reflections on Bank Bail-ins' (2015)1(1) Journal of Financial Regulation p. 3

mismatches, to ensure dynamic countercyclical provisioning, and to promote surveillance and data collection. As an example of overly broad regulatory measures, the European Union's adoption of the BRRD provides authorities with a choice of several resolution tools to ensure that an institution can fail safely during periods of market distress. Neither European nor national guidance exists on the when, what and how of resolution.[72]

(d) Criticism

It is noticeable that none of the terms contained in the objectives is defined in the Banking Act 2009. Nor are the objectives ranked. This is not inadvertent since the construction is highly "context-specific" and eludes a comprehensive, single definition.[73] The Code of Practice provides guidance as to the interpretation of all objectives. Since only 'regard to' the objectives is required, certainty is substantially undermined.[74] Therefore, the BoE instituted the self-imposed "overarching financial stability remit or public interest test".[75] One severe deficiency remains: it suffers from subjectivity.

The no-creditor-worse-off principle is vital in this context. Since resolution constitutes a relatively new regime, insolvency serves as a benchmark. Attribution of losses in accordance with the insolvency hierarchy is inevitable. Since resolution is initiated before insolvency, the simulation of a counterfactual is elusive. Therefore, attribution of losses is only possible under broad assumptions incorporating other, broader considerations. This approach is susceptible to error, and, by implication, property rights are not adequately protected. As a consequence, it represents a significant dependency. The simulation of a counterfactual requires a high level of abstraction and assumption. That does not suggest that the hindsight principle should be applied in the valuation.

The above conditions that should shape or confine the resolution strategy suffer from high subjectivity. Due to the enormous power, the Banking Act 2009 envisages that the powers are being exercised at arms-length.[76] Moreover, the Banking Act 2009 establishes checks and balances. Given that intervention requires agreement between the BoE and HM Treasury, the degree of accountability may not be a primary issue. Both institutions embody the requisite expertise and legitimacy. As regards HM Treasury, its consent will be required in the event that (i) the envisaged measure contravenes international obligations, (ii) it implicates "public funds" or (iii) there are overriding public concerns in relation to public funds.[77] The latter will inevitably require the HM Treasury's consent.

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72 What options will be applied, when and in what circumstances and how these should be calibrated is unclear

73 See section 5 of the Code of Practice

74 See Roman Tomasic, 'Creating a template for bank insolvency law reform after the collapse of Northern Rock: Part 2' (2009) 22(6) Insolvency Intelligence

75 The Bank of England's Financial Stability Paper No 5 – July 2009, 'The UK Special Resolution Regime for Failing Banks in an International Context' by Peter Brierly

76 Mark Hsiao, 'Legitimised interference with private properties - Banking Act 2009' (2010) 25(5) Journal of International Banking Law and Regulation p. 227, p. 229

77 See Rodrigo Olivares-Caminal, John Douglas, Randall Guynn, Alan Kornberg, Sarah Paterson, Dalvinder Singh, Hilary Stonefrost, *Debt Restructuring* (Oxford University Press 2011) p. 265

The initiation of resolution also suffers from high subjectivity. Although there are guiding considerations,[78] market participants cannot exactly predict the moment when their transactions will be affected, and what will be the consequences. A consequence includes whether a non-defaulting party must invite quotes for replacement trades or await notification from the BoE. A complicating factor is the abovementioned Henry VIII clause, which allows the BoE to make amendments to the law and impose measures with retrospective effect.[79] Mere "desirability" may not constitute a ground to invoke the Henry VIII clause, as stated upon the introduction of the Banking Act 2009.[80] This clause is strictly reserved for emergency situations, and application will attract a high level of scrutiny.

Procedural fairness is thus of crucial concern. It is shaped by "concerns about controlling regulatory behaviour, particularly the exorbitant exercise of regulatory discretion".[81] Under pressure to act in order to avert distress, authorities "provided with extensive regulatory tools will have an overwhelming desire to exercise them".[82] The prevention of property rights violations is notoriously difficult given the convoluted valuation. A court will impugn an authority's decision only if it is manifestly incompatible with the purported reasoning, e.g. if it relates to public interest.[83] The fact that the outcome differs from the contractually envisaged outcome or is relatively undesirable from an economic perspective will not form part of the court's considerations. Thus, although there is, in principle, some governing principle as well as protection by courts, the risk allocation mechanism established by the master agreements may be overridden, including its economic effects.

The above suggests that the no-creditor-worse-off principle represents a pretext rather than provides substantial protection of contractual rights or a remedy.[84] In this context, it should be noted that the write-down of contracts may be inadvertent and not serve a pre-determined purpose. In general terms, this may contribute to the "fear of fear" and affect contractual relationships with institutions that are most likely to be subject to resolution measures, which is dependent on the involvement and experience of the resolution authorities in the relevant jurisdiction. Whilst the BoE seems to be agonisingly aware of potential ramifications, it should be noted that decisions will be taken during times of distress. Although a resolution measure may be falsely perceived as a single act, the measure may create a treacherous precedent.

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78 The PRA or FCA may consider (i) the extent of adverse effects of failure on depositors and market participants, (ii) the anticipated seriousness of the breach of the FSMA, (iii) the risk posed to financial stability by the financial institution, and (iv) the merits of the remedial actions in relation to the promotion of market confidence

79 See section 5.2.5

80 The report of the House of Lords Select Committee on the Constitution states that "[w]e note Lord Myners' statement that section 75(3) of the Banking Act 2009 'does not set a precedent for the use of retrospective powers'. The fact of the matter is, however, that a precedent has been set. It is not, in our view, an acceptable precedent", see House of Lords Select Committee on the Constitution, 11th Report of Session 2008-09, Banking Act 2009: Supplementary report on retrospective legislation, HL Paper 97; see also Rodrigo Olivares-Caminal, John Douglas, Randall Guynn, Alan Kornberg, Sarah Paterson, Dalvinder Singh, Hilary Stonefrost, *Debt Restructuring* (Oxford University Press 2011) p. 267

81 Sarah Paterson, 'Debt restructuring and notions of fairness' (2017) 80(4) Modern Law Review p. 600, p. 621

82 Ibid

83 See *SRM Global Master Fund LP & Ors v Commissioners of HM Treasury* [2009] EWCA Civ 788

84 See Victor de Serière and Daphne van der Houwen, 'No creditor worse off" in case of bank resolution: food for litigation?' (2016) 31(7) Journal of International Banking Law and Regulation p. 376

6.2.2.2 Interaction with the judicial regime

After having considered the discretion and powers of the BoE, this subsection will examine to what extent that resolution can be reconciled with existing insolvency law and whether resolution marks a departure from creditor rights as traditionally protected by courts.

(a) Resolution

Fransico Garcimartín succinctly described the BRRD as a "new framework [which] is *procedurally* administrative law, but substantially insolvency law".[85] The reason is that the no-creditor-worse-off principle ensures that the effect of the resolution measures on creditors is akin to that of insolvency law. He proposes a test containing two limbs.[86] First, the statutory creditor hierarchy must be observed. Second, the treatment of creditors under resolution and insolvency must be equal. The latter implies that if a creditor receives worse treatment under resolution than in hypothetical insolvency, he will be entitled to compensation. Moreover, from an insolvency law perspective, none of the resolution measures is a substantive legal novelty – what is different is mostly the form of application and the moment of initiation.

(b) Bank insolvency and administration

The foregoing discussion does not suggest that courts have also been substituted within insolvency. In fact, they must make bank insolvency or bank administration orders and will appoint a liquidator or administrator,[87] respectively. In addition, the courts must supervise the process and are permitted to remove the insolvency practitioner, if necessary. In bank administration,[88] the administrator can also seek directions of the courts as to the effect of the terms of a particular agreement between the residual institution and the transferee.[89] This right does not confine the ability of the administrator to achieve Objective 1, i.e. the promotion of financial stability.[90] To reiterate, Objective 1 takes precedence over Objective 2, namely the rescue of the debtor which is the aim of ordinary administration.[91] If the bank administrator disagrees with the BoE on the statement for achieving its objectives, the administrator can apply for directions.[92] A court order may also entail that the bank administrator may "dispense with the need for the BoE's agreement".[93] The Banking Act 2009 nevertheless requires that the bank administrator concedes to the BoE's requests, including the provision of information as deemed necessary by the BoE and HM Treasury.[94] Prior to the satisfaction of Objective 1, the BoE is entitled to participate in the administration.[95]

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85 Fransico Garcimartín, 'Derivatives in Cross-border Insolvency Proceedings' in Dennis Faber and Niels Vermunt (eds) *Bank Failure: Lessons from Lehman Brothers* (Oxford University Press 2017) para 14.36

86 (Emphasis added) see Fransico Garcimartín, 'Derivatives in Cross-border Insolvency Proceedings' in Dennis Faber and Niels Vermunt (eds) *Bank Failure: Lessons from Lehman Brothers* (Oxford University Press 2017) para 14.36

87 Section 146 of the Banking Act 2009

88 See section 5.4.1.2

89 It follows the traditional procedure pursuant to para 63 of Sch B1 to the Insolvency Act 1986

90 Section 138(4)(b) and (c) of the Banking Act 2009

91 Secton 140 of the Banking Act 2009

92 Para 63 of Sch B1 to the Insolvency Act 1986

93 See section 147(5) of the Banking Act 2009

94 Section 148 of the Banking Act 2009

95 See para 63 of Sch B1 to the Banking Act 2009

The regimes on bank insolvency and administration contain amended avoidance rules.[96] Again, the aim is achievement of Objective 1. Interestingly, the court is required to consider this objective in making the respective order. This will necessitate coordination with the BoE

6.3 Safeguards and protection

Due to the intrusive nature of the stabilisation options, institutions subject to resolution and third parties benefit from a range of safeguards, which must maintain market confidence.[97] The subsections below discuss a selection of safeguards and additional protections. In addition, an analysis is provided of the potential risks and remedial measures introduced by the legislator and BoE.

6.3.1 Safeguards orders

Safeguards orders establish various protective measures that were introduced as statutory instruments with the propensity to modify the Banking Act 2009. These orders can be made under regulations, which are discussed below. These regulations specify necessary or desirable protections in respect of creditors of a financial institution and which existed before the initiation of the partial property transfer. Together, the orders must provide sufficient certainty for financial market participants transacting with UK financial institutions. Due to the capacity of the stabilisation measures to disrupt credit risk mitigation techniques, unrestrictive application will jeopardise, amongst others, the capital relief granted under the CRR.[98]

6.3.1.1 Partial property transfer safeguards order

The Banking Act 2009 (Restriction of Partial Property Transfers) Order 2009[99] probably provides the most essential protection. As discussed earlier, unrestricted application of a partial property transfer may disrupt credit risk mitigation arrangements or render them unenforceable. In accordance with Art 5(2) of the Partial Property Transfers Order 2009, a partial transfer requires the concurrent transfer of the rights or property against which a liability is secured, together with the liability itself. Security is defined in section 48D(1) of the Banking Act 2009, encompassing the exchanging an of collateral via title transfer.[100]

(a) Rationale

It should be recalled that the BoE's preferred resolution measure is the transfer tool. In case it is impossible to transfer the whole financial institution, the order will prescribe a partial transfer.[101] As a potential consequence of the partial property transfer, contractual arrangements may be separated. For instance, only distressed assets may remain in the residual institution, whereas critical assets such as deposits will be transferred to a third entity. During the legislative process of

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96 See section 2.4.3

97 Below not all protection orders are discussed as they are in immaterial for the purpose of close-out netting. The orders not discussed are the Banking Act 2009 (Exclusion of Investment Firms of a Specified Description) Order 2014 and the Banking Act 2009 (Banking Group Companies) Order 2014

98 See section **3.1.3**

99 As amended by the Banking Act 2009 (Restriction of Partial Property Transfers) (Amendment) Order 2009

100 However, with regard to CCPs, applicability may be restricted, see 48D(1) of Banking Act 2009

101 See section 5.1.1

the Banking Act 2009, market participants and the legislator were concerned that contractual arrangements might be separated. The effect of this separation may be that only individual contracts under a master agreement or relevant collateral are transferred. Due to the separation, the arrangement will fail to satisfy the crucial precondition of mutuality,[102] and thereby the credit risk mitigation arrangement may be rendered void.[103] Even if the arrangements are still effective, special insolvency or administration proceedings will be initiated against the residual institution. Considering that the proceedings envisage the disposal of assets and liabilities so as to achieve the respective objectives, it cannot be ensured that all parts of the arrangement can be enforced when required.

It is evident that resolution encompasses measures that can significantly interfere with rights of creditors, including early termination rights, and with the operation of credit risk mitigation techniques. In addition, unrestricted power to effect a partial property transfer allows the resolution authority to transfer only profitable and otherwise beneficial contracts. Its effect is that the residual institution will be burdened with less beneficial contracts while being deprived of valuable assets. The general body of creditors of the residual institution will hence receive worse treatment than in ordinary insolvency. Unsurprisingly, market participants and trade associations have asserted thatresolution represents a significant risk to financial markets. The reason is that credit risk mitigation techniques that are uncertain or potentially unenforceable will not qualify as risk-mitigating mechanisms for the purpose of the CRR, thereby reversing the capital charges-reducing effect.[104] It has been asserted that potential risks include widespread termination of financial contracts since financial institutions cannot comply with the consequential capital surcharges and a substantial increase of costs linked to hedges. In addition, it will disproportionally affect UK financial institutions , thus prejudicing the ability to compete with EU and US peers.

(b) Effect

The safeguard entails that a partial transfer involve the transfer of some, but not all, of all the rights and liabilities comprised under a set-off, close-out netting or title transfer financial collateral arrangement. It is unclear whether the protection covers all types of financial derivatives. For example, arrangements comprising spot and forward foreign exchange transactions, and certain non-financial options and futures may be disrupted. In the worst case, the inclusion of a transaction not qualifying for protection may contaminate the arrangement, which, consequently, may fall outside the scope of the safeguards. A transfer order instrument is necessarily conceptual in relation to the assets and liabilities that will be subject of the transfer.[105] Due to time constraints, it cannot be expected to have such granularity as in an ordinary merger and acquisition transaction. Recovery and resolution planning completed with the solvent wind-down plan should facilitate the development

102 Section 2.1.2.2(a)

103 Security arrangements, which broadly means collateral arrangements, may not be divided as a result of partial property transfer pursuant to Article 5 of the Safeguards Order

104 See section 3.1

105 Samantha Bewick and Richard Heis, 'The special resolution regime: what happens in practice?' (2010) 4 Corporate Rescue and Insolvency p. 139

of the transfer order instrument.[106] In addition, the BoE has the authority to order subsequent transfers and re-transfers.

In relation to close-out netting and collateral arrangements, there are certain protections from bail-in. According to Art 4 of the Banking Act 2009 (Restriction of Special Bail-in Provision, etc.) Order 2014, the special bail-in provision cannot be applied against protected liabilities.[107] Thus, if set-off or close-out netting has not been exercised, but liability is nevertheless the subject of such an arrangement, the arrangement will still be protected from the application of bail-in. Consequently, rights under close-out netting arrangements cannot be rendered ineffective; it is impossible to transfer the arrangements in parts. However, this does not affect the transferrability of specific arrangements irrespective of the requirements or needs of the non-defaulting counterparties.

(c) Consequences for resolution

The existence of the aforementioned safeguard undoubtedly guides and creates dependencies for resolution. First and foremost, it shapes the basis of the transfer. Although facilitating administration, the transfer must occur on a counterparty-by-counterparty basis, not asset by asset. Thus, this requires considering the overall value of an existing relationship, not just the value of an asset for a transferee. Counterparties can expect to become part of the transfer if the transactions constitute essential services such as for the purposes of hedging.[108] Thus, not all counterparties of the distressed institution will be treated similarly. It can be expected that certain counterparties that have not been transferred may also be allocated losses, e.g. as a result of the application of bail-in.

6.3.1.2 Third-party compensation arrangements order

With the application of the partial property transfer order, only some creditors become creditors of the transferee, whilst others remain creditors of the residual institution. The Banking Act 2009 (Third Party Compensation Arrangements for Partial Property Transfers) Regulations 2009[109] apply to the latter group.

(a) Rationale

The Regulations set out the relevant provisions for third-party compensation orders. In addition, an order is required containing provisions on the appointment of an independent valuer, the calculation of compensation based on the no-creditor-worse-off principle, and the necessary consideration of an independent valuer.

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106 See Michael Eichhorn and Philippe Mangold, 'Reverse stress testing for banks: a process-orientated generic framework' (2016) 31(4) Journal of International Banking Law and Regulation p. 211

107 Art 4(2) of the Banking Act 2009 (Restriction of Special Bail-in Provision, etc.) Order 2014 provides that a protected liability is a liability which (i) is owed by the financial institution subject to the resolution measure against a particular person, (ii) is eligible under a set-off or close-out netting arrangement, and (iii) cannot be converted or be deemed to be converted into a net claim

108 The notion of financial stability is elusive without considering the direct implications resulting from a distressed financial institution. The Code of Practice defines financial stability as "stability of the financial system of the UK" and refers to "the stable functioning of the systems and institutions (including trading, payment and settlement infrastructure) supporting the efficient operation of financial services and markets for purposes including capital-raising, risk-transfer…" see HM Treasury, *Banking Act 2009: Special resolution regime code of practice* (revised March 2017) para 3.7. Thus, it is questionable to what extent this notion can be invoked to motivate the transfer of certain financial contracts

109 SI 2009/319

(b) Effect

As witnessed during the financial crisis of 2007, challenges based on breaches of the principle of equal treatment of shareholder and creditor can represent significant impediments to crisis management. During the crisis, this problem was exacerbated in the absence of appropriate safeguards relating to the intrusive powers of the resolution regime. Therefore, Articles 74 and 75 introduced the reaffirmation and protection of the equitable treatment principles. However, these provisions may inadvertently diminish the ability to bail in financial contracts. Pursuant to these articles, ex-post valuation serves to determine infringement of the NCWO principle. If the assessment concludes that the principle will indeed be infringed, the affected party must be compensated. When considering the position of financial contracts in traditional insolvency proceedings, it is evident that such infringement is likely. Due to the complexity inherent in the valuation and the implications of early termination of claims, litigation is inevitable.

In the case of a bail-in safeguards order, to the extent that transactions qualify as "derivatives" or "financial contracts" as defined therein or the agreement as a "qualifying master agreement", the operation of the close-out netting provisions of the agreement will be efficiently protected. In the case of banks and other entities subject to the special resolution regime under the Banking Act, enforcement is not permitted solely on the basis of a resolution measure. In addition, pursuant to section 70A to C of the Banking Act, the right to enforce a security interest may be suspended; the suspension period must end no later than midnight of the first business day following the publication of the notice of suspension.

6.3.2 Other protective measures

The above subsection has considered substantive protections. However, effective protection consists of two parts. First, what is protected and, second, how it is protected, thereby mitigating the risk of any disproportionate use or abuse of power. This subsection discusses soft protection contained in quasi-legislature, self-imposed restrictions and (more inadvertent) protection by implication. The next chapter discusses what rights need to be protected and relevant remedies.

6.3.2.1 Code of practice

In acknowledgement of the uncertainty related to the bail-in measure, stabilisation powers, bank insolvency procedure and bank administration procedure, the Banking Act 2009 states that HM Treasury shall issue a code of practice.[110] Codes of practice (also known as codes of conduct) are frequently employed instruments that instruct regulatory bodies on their behaviour in relation the exercise of a statutory function. The code of practice must be construed in accordance with the Banking Act 2009 and provides guidance in respect of the exercise of the bail-in measure. However, its function is not merely advisory;[111] any departure from the code needs to be justified and proportionate. In fact, such departure requires the "strongest of reasons". Consequently, the BoE needs to ascribe considerable weight to the code. Although no criminal or civil liability can arise from

[110] Sections 5 and 6 of the Banking Act 2009
[111] *R (Munjaz) v Mersey Care NHS Trust* [2005] UKHL 58

a breach, the code provides certainty to market participants. An alleged offence requires enforcement through judicial review

6.3.2.2 The Bank of England's approach

In October 2014, the BoE published its envisaged approach to resolution.[112] The bail-in measure contains the following "four core elements". The first core element describes the preliminary stages for the preparation of the so-called resolution weekend. During this time, the BoE is expected to prepare a "draft resolution instrument" which sets out the terms of the bail-in measure and gives legal effect to it. Part of this exercise will be a preliminary valuation of the assets and liabilities that are eligible for bail-in. The second core element is the period during which the bail-in is applied, including the resolution weekend. During this time the amount is determined that is needed to replenish the capital position of the financial institution or to fund the resolution scheme. During the resolution weekend, a list of classes of shares and debt instruments that will be subject to bail-in will be published. To ensure that no significant systems will be affected, the FCA may suspend the trading of the relevant instruments. This period also involves the actual application of the bail-in measure. In conjunction with the suspension, the BoE appoints an (existing, private) depository bank for the shares and debt instruments that will be subject to the bail-in measure, as well as a resolution administrator. From this point in time, the depository will act as trustee. Subsequently, the valuation will progress further to ensure that sufficient debt instruments are available for bail-in and that the estimates are robust enough. The BoE stipulates that this period should be as short as possible.[113] Still, the length of this period may range between two and three weeks, depending on the complexity of the capital structure, e.g. the different layers and the amount of foreign-denominated debt

The BoE has provided some guidance as to the possible exercise of its powers.[114] In contrast to its European counterparts, the BoE, as resolution authority, divides resolution into three phases, i.e. (i) the stabilisation phase, (ii) the restructuring phase, and (iii) the exit from resolution.[115] It expects that these stabilisation powers will, in principle, be applied to those financial institutions with "total transactional accounts over 40,000 and a balance sheet up to GBP 15-25 billion".[116] The special resolution regime provides for five stabilisation options: transfer to a private sector purchaser; transfer to a bridge bank; transfer to an asset management vehicle; bail-in; and transfer to temporary public sector ownership. The restructuring phase prepares the distressed financial institution, or its systemically relevant parts, for the continuation of its operation. Once the preparation has been completed, which will allow the financial institution to operate without further support from the BoE, it will enter the exit phase.[117] For the commencement of the stabilisation measures and throughout their application, the BoE must have regard to the intervention objectives. It includes, amongst others, protection and enhancement of the stability of the UK financial systems, including the

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112 Bank of England, *The Bank of England's approach to resolution (2014 and updated in October 2017)* available at http://www.bankofengland.co.uk/financialstability/Documents/resolution/apr231014.pdf <accessed on 18 December 2017>

113 Ibid p.19

114 Ibid

115 See Ibid, p. 15

116 International Monetary Fund, United Kingdom; Financial Sector Assessment Program; Bank Resolution and Crisis Management – Technical Note (2016) IMF Country Report No 16/155 p. 23

117 See Figure 4 (Stages of resolution) in BoE approach n (112)

continuity of banking services; the protection and enhancement of public confidence in the stability of the UK banking systems; the protection of depositors; the protection of client assets; and the avoidance of interference with property rights in contravention of a convention right.[118]

Regarding the latter objective, resolution authorities are certainly given unprecedented powers to intervene with private contracts. Application of this measure is therefore subject to a safeguard that seeks to protect confidence in the protection of (insolvency) creditor rights. This safeguard is known as the no-creditor-worse-off principle. It compares the outcome of a hypothetical insolvency procedure or restructuring measure with the expected outcome of the resolution measure. If the calculation shows that a resolution would destroy more value for creditors than a hypothetical insolvency procedure or restructuring measure and that the creditors would be treated less beneficially, the resolution measure will be rejected. If the insolvency procedure or restructuring measure involves a less beneficial treatment of certain creditors only, these affected creditors may be entitled to receive compensation.

However, this also represents a significant departure from the traditional understanding of the *pari passu* principle. It is submitted that the no-creditor-worse-off principle acts *in lieu* of *pari passu*. In fact, this principle is understood to be an implicit empowerment of the BoE to depart from the *pari passu* principle.[119] The reason is that uncertainty may ensue in the absence of such protection. On balance, it is apparent that the conservation principle cannot form part of the resolution regime. This is a natural consequence considering the unique nature of financial institutions in relation to the objectives of resolution. Consideration of insolvency creditors is not a direct concern, but is of indirect relevance if it results in uncertainty. The conflicting objectives lead to a distortion of the scope of the resolution. As mentioned above, the no-creditor-worse-off principle, protecting equal distribution, is more appropriate to promote fairness and certainty.

6.3.2.3 Insolvency hierarchy

The ranking of eligible liabilities determines the likelihood of them becoming subject to bail-in. Although not being protection in the strict sense, a measure that increases the seniority of claims arising from financial contracts provides more security. This subordination can be achieved either contractually or structurally. [120]

6.4 Insolvency law as the standard

Overall, the treatment of counterparties in resolution should not differ from that in insolvency. As mentioned above, direct intervention is limited by the no-creditor-worse-off principle, which requires simulation of a counterfactual informed by insolvency law. Therefore, insolvency law continues to have a prominent role. The above sections have criticised certain insolvency law principles, such as

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118 For instance, Art 1 of the First Protocol of the European Convention on Human Rights

119 See International Monetary Fund, United Kingdom; *Financial Sector Assessment Program; Bank Resolution and Crisis Management – Technical Note* (2016) IMF Country Report No. 16/155 p. 6

120 "Structurally" refers to the position of the transacting entity within the group. A parent institution's claims are subordinated to those of its subsidiaries

pari passu, which do not enjoy the standing commonly ascribed to them. It is not surprising that the resolution authorities can override the *pari passu* principle if necessary. [121] Insolvency does not operate in a legal vacuum. On the contrary, it needs the outside statutory framework and case law, including trust and equity. This means, for instance, that although insolvency can affect contracts and transactions, the ultimate implications are governed by general principles of law. An example is that a disposition in contravention of the rule governing the disposition of property after the commencement of liquidation requires that the ordinary principles of equity be invoked to trace the property, restitution or rescission.[122]

It also implies that recovery could be challenged by the presence of a *bona fide* purchaser, also referred to as equity's darling. This purchaser is beyond the inherent equitable jurisdiction of the courts since he executed the transaction without knowledge of the impending or actual insolvency and offered valuable consideration commensurate with the value of the good received. Any claim thereby attaches to the value received by the debtor.[123] Affected creditors can also challenge such restriction by applying to the court for a validation order pursuant to section 284 of the Insolvency Act permitting the disposition after commencement of the relevant proceedings. A court will grant leave if the disposition is not prejudicial to the general body of creditors and will examine the merits of the application.

Gallagher and Shepherd discerned the grounds for applying for a validation order from a leading authority.[124] These grounds are: (i) completion of a contract; (ii) sale of an asset as market value; and (iii) sale as a going concern.[125] The first ground is predicated on the assessment that the disposition serves the completion of an ongoing undertaking. This implies that the rehabilitation of the debtor is more valuable than its dissolution. The second ground is that the value received in the disposition is commensurate with the value of the property. For present purposes, the third ground is crucial, namely parts of or the whole debtor will be continued as a going concern. Therefore, honouring and thereby maintaining the contractual obligations after commencement of the relevant proceedings is most beneficial. As a collorary substantive obligations must be continued in resolution. This is a general principle and applicable to all legal entities, irrespective of systemic concerns, and must therefore be of relevance in case of resolution.

Overall, courts construe the statute and the general principle in light of the situation, but there must be some consistency with regard to the implications. Moreover, insolvency converts pre-insolvency "rights into a right to prove for a dividend in the liquidation".[126] These conjectures also inform

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121 International Monetary Fund, United Kingdom; Financial Sector Assessment Program; Bank Resolution and Crisis Management – Technical Note (2016) IMF Country Report No. 16/155 p. 23

122 See *Re J Leslie Engineering Ltd* [1976] 1 WLR 292 [at 298] and Gerard McCormack, 'Equitable influences and insolvency law' (2014) 7(3) Corporate Rescue and Insolvency p. 103, p. 104

123 See *Rose v AIB Group plc* [2003] 1 WLR 2791 and *Barclays Bank Ltd v Quistclose Investment Ltd* [279]

124 The leading authority is *Express Electrical Distributions Limited v Beavis and Ors* [2016] EWCA Civ 765 and *Re Gray's Inn Constructions* [1980] 1 WLR 711, see Adam Gallagher and Jack Shepherd, 'Express Electrical Distributions: Sparking new life back into the pari passu principle' (2017) 14(1) International Corporate Rescue p. 36

125 See Gallagher and Shepherd (n 124) p. 64

126 See *Re Lehman Brothers International (Europe)* [2012] UKSC 6; [2012] 1 BCLC 487, see also Gerard McCormack, 'Equitable influences and insolvency law' (2014) 7(3) Corporate Rescue and Insolvency p. 103, p. 104

resolution. Thus, although there are exceptional circumstances that require extraordinary measures, there are fundamental and overriding principles. It holds true both in insolvency and resolution.

6.4.1 Transfer

Creditors that were not subject to the transfer order and have remained at the residual institution, which is subject to liquidation or administration, are entitled to exercise their termination and enforcement rights in accordance with the master agreement. A particular master agreement may also be subjected to bail-in, before the transfer. Hence, the creditors may become creditors for any uncollaterised amount. This bears resemblance to schemes of arrangement for companies. If the measure is linked with a pre-packaged administration sale, the junior creditors remain at a shell company, without recourse to any insolvency dividends.

The unfairness inherent in the scheme described above is actionable.[127] A court will analyse whether creditors of the residual institution maintain an economic interest in the transferee in order to determine whether these creditors qualify for some compensation. As part of the analysis, a court will examine the effects of a counterfactual, i.e. under the assumption that the scheme was not sanctioned. [128]

6.4.2 Bail-in

There are two conceptually different forms of bail-in.[129] The first is the direct application of bail-in, which allows *in situ* recapitalisation. While the write-down or write-off allows alleviating the balance sheet, the conversion permits re-establishing the regulatory prescribed Tier 1 ratio. In principle, this form of bail-in mirrors debt-to-equity swap, as suggested by Christophe Thole. [130] Debt-for-equity forms part of composition arrangements, whereby debt investors agree on the modification of their investment in order to reduce the probability of a complete loss of their interest. Court determinations may also involve a debt-for-equity swap in administration in order to rescue the ailing entity. However, there a pronounced differences, not least with regard to the intrusiveness. A bail-in permits the contractual modification without the creditors' consent. In addition, the application is not as straightforward given the more complex capital structure of financial institutions. Most notably, trade creditors are not within the scope of such debt-for-equity swap.

In contrast, the second type of bail-in is the indirect application, which requires concurrent transfer. The rationale is that by reducing the liabilities of the transferred parts,[131] the transferee assumes fewer costs. Consequently, the transferee is enticed to preserve the distressed business encompassing deposits and other functions of systemic relevance. By implication, it funds the resolution measure. In contrast, direct application of bail-in does not require a transfer. Resolution

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127 See Sarah Paterson, 'Debt restructuring and notions of fairness' (2017) 80(4) Modern Law Review p. 600, p. 613

128 *Re MyTravel Group plc* [2004] EWCA Civ 1734 and *Re Bluebrook Ltd* [2009] EWHC 2114 9 Ch; [2010] BCC 209

129 Simon Gleeson and Randall Gyunn, *Bank Resolution and Crisis Management: Law and Practice* (Oxford University Press 2016) para 10.1

130 See section 6.1.3 and Christophe Thole, 'Bankenabwicklung nach dem SAG' (2016) 28(2) Zeitschrift für Bankrecht und Bankwirtschaft, p. 67

131 See section 5.1.1

authorities may cancel, modify or change the form of the liabilities owed by the financial institution in order to apply the special bail-in provision.[132]

While there are similar measures under insolvency law, loss attribution must consider the effects of a full liquidation or administration proceeding. A consequence is, however, that loss attribution does not have the same granularity and involves a higher level of abstraction, which is susceptible to errors. Errors are not unlikely given the predisposition of the parties involved.

6.4.3 Valuation

The justification for the convoluted methods follows intuitively from the multifaceted operations and involved financial instruments. Primarily, the valuation must follow the mechanisms set out in the master agreements. This methodology may not be realisable at all times and may be disregarded for the purpose of timely execution of the resolution measures. To devise a resolution strategy, an independent valuer will ascertain first the claims and obligations, but also the bail-inable amount and the required rate of conversion. The institution therefore has to be valued as a going concern. Once bail-in has been applied, a secondary valuation will be executed. In contrast to the first valuation, the marked-to-market value of the transactions will be considered.

Financial contracts, particularly financial derivatives, have no market prices but are subject to methodologies set out in the master agreement. One vital distinction is the bilateral nature of these contracts; they do not emulate the promissory payments of one party but represent a contract of bilateral obligations. Thus, even though default impedes one party from discharging its obligations, the non-defaulting party may wish or need to continue honouring the contract. Both valuations will therefore consider a valuation as going concern. The Banking Act 2009 contains, besides regulatory technical standards developed by the European Banking Authority, alternative methodologies. Since these methods are untested, the BRRD and, by implication, the Banking Act 2009 contain an express right to appeal. Affected creditors bear the burden of proof to impugn the assumptions or valuation methodology.

6.5 Conclusion

The ability to interfere with financial contracts is evident from the consequential amendments to the legislation protecting credit risk mitigation techniques. This does not, however, constitute a paradigm change. Under European law, the protection of credit risk mitigation remains a primary objective and can only be restricted in resolution. Hence, there is no general presumption against the enforceability of *ipso facto* clauses and credit risk mitigation techniques such as under US jurisprudence. Intervention is strictly limited to resolution and subject to prior satisfaction of requirements that balance the notions of public interest and private interest. It motivates the need for intervention. However, the degree of intervention remains questionable.

[132] Section 48B(1) of the Banking Act 2009

6.5.1 Efficacy of the safeguards and the no-creditor-worse-off principle

The BRRD and, by implication, the Banking Act 2009 contain vital safeguards that prevent the separation of close-out netting and collateral arrangements and preclude partial enforcement. However, these regimes contain powers for early termination and valuation not respecting the terms of the master agreement, and for the cancellation, write-down or conversion of claims as well as for the disparate treatment of creditors depending on whether they were transferred or have remained at the residual institution. Thus, counterparties may receive worse treatment in resolution, despite the safeguards.

The no-creditor-worse-off principle militates against that risk. It compares the outcome of the resolution with a counterfactual under insolvency law. The practicalities and level of abstraction make protection under the no-creditor-worse-off a non-viable and superficial solution, in particular for the purpose of compensation. It thus provides little comfort. A dependency is therefore that the powers are executed in a normatively defensible manner. Contravention sets dangerous precedents, whereby the market for credit and market risk mitigation may contract, with direct implications for the real economy.

6.5.2 Implications for contractual risk allocation

The no-creditor-worse-off principle undermines contractual risk allocation and affects the terms on which financial institutions are prepared to transact. It begs the question of legitimacy. Courts, which have been traditionally entrusted with safeguarding creditor rights in insolvency, only play a secondary role in resolution. They have maintained this role under the modified insolvency regimes relating to financial institutions. Their expertise, objectives and predisposition differ fundamentally from the BoE's. Thus, it is also questionable to what extent insolvency may serve as a standard and can protect creditor rights.

Despite these problems, the European legislator seeks to further expand the intervention powers. It has been submitted that this is based on a failure to appreciate the purpose and characteristics of financial contracts as well as the market response. It contravenes global consensus, thereby affecting the competitiveness of European financial institutions.

Chapter 7
Conclusion

This thesis has assessed the value and risks of financial contracts and credit risk mitigation techniques in the context of the evolving bank insolvency and resolution framework in the UK. It asserts that, before the financial crisis of 2007, contractual risk allocation under the master agreement migrated to a regime empowering the Bank of England ("BoE") to intervene. In effect, the BoE has become risk manager of the financial system. The objective of this last chapter is to reflect on the balance between policy, principles and practicalities. In particular, financial institutions require pre-emptive measures; intervening too late can propagate financial distress, which can transcend the originally affected financial institution. As a result, the intervention may be disproportionate or may cause certain creditors to suffer losses that they would not have incurred otherwise. It is vital to substantiate the calibration of intervention and reliance on credit risk mitigation techniques.

While impossible to comprehensively demarcate the risks and benefits of credit risk mitigation techniques, this thesis has set out to militate against common misperceptions. The widely held prejudices in academia and among policymakers suffer from various deficiencies. The question on the legitimacy of close-out netting cannot be answered without due regard to the legal and situational context. Hence, the following sections aim to reiterate the conjectures of this thesis and to provide a comprehensive overview. This chapter is structured as follows.

The first section reflects on the benefits and challenges of close-out netting. It should be remembered that financial systems are highly intraconnected. Thus, regulation of one institution will have direct implications for another institution. Even within credit risk mitigation techniques, there is manifest interdependence between close-out netting and collateral. Restriction of the ability to net will affect the availability of credit support, which, in turn, will affect credit terms.

The second section pinpoints the significant developments shaping the current resolution regime applicable to distressed financial institutions. A cornerstone is the resolution framework, which empowers resolution authorities to instigate insolvency-like measures, including allocation of losses, before insolvency. The macro-prudential approach to regulation and the preservation of critical functions together motivate a resolution authority's intervention.

The third section highlights the tension between resolution and substantive rights of creditors. It asserts that while the resolution regime has conferred significant powers on resolution authorities, the merits of the safeguards and protection are uncertain. In fact, the protection seems somewhat superficial and artificial. This section questions the base of resolution authorities' intervention; in particular, resolution entails a reduction in the powers of insolvency-experienced courts.

The fourth section contextualises the enforceability of close-out netting and collateral in the evolving financial institution insolvency and resolution regime. It reiterates the value of credit risk mitigation

techniques. Inherently, against the background of the foregoing sections, this section warns against the disproportionate expansion of resolution powers that affect the enforceability of credit risk mitigation techniques.

The fifth section contemplates the proposed expansion of intervention powers. This section argues that this proposal is based on a failure to appreciate the purpose and characteristics of financial contracts, as well as the market response. Although the expansion of intervention powers should primarily protect the liquidity of credit institutions, potential failure to carve out financial contracts from the scope can have severe ramifications. However, carve-out would constitute an awkward policy decision. Overall, this section suggests that although resolution seeks to contribute to financial stability, it is subject to the political whim.

7.1 Financial contracts and credit risk mitigation techniques

Close-out netting raises challenging issues, the chief one of which is the interaction with insolvency law. The above discussion has illustrated that the risks ascribed to close-out netting are negligible. The belief that close-out netting interferes with or is detrimental to other creditors is fundamentally flawed. In short, it does not alter the creditor hierarchy. Limiting the ability to exercise close-out netting rights negates the benefits of financial contracts and the credit risk mitigation benefits of close-out netting, which is to allow market participants to allocate risk.

Thus, policy reasons relating to the need to allow market participants to mitigate and allocate risk justify the current, robust legal framework. This framework requires certainty, which emanates from the enforceability of credit risk mitigation techniques in accordance with the terms of the agreement. Concurrently, it requires that any interference be based on strict conditionality. The financial crisis demonstrated that extraordinary times demand extraordinary measures. Thus, proportinate interference may be justified; however, any measures that causes greater losses than would have been incurred in insolvency must be compensated.

In contrast to popular belief, safe-harbour provisions are required solely in jurisdictions that prohibit *ipso facto* clauses. Since close-out netting emulates set-off, which is firmly ingrained in English law, its effects do not subvert or defeat the purpose of insolvency. It is also supported by the principles of party autonomy. Consequently, enforcement of close-out netting does not offend insolvency law. Thus, the discussion challenging the legitimacy of safe-harbour provisions is not relevant in the English law context. This enforcement fallacy represents the most widespread argument regarding the restriction of close-out netting and it has been formed part in the formulation of the BRRD. This fallacy and its consequences illustrate the limited justifications for intervention. Conversely, credit risk mitigation techniques are the mainstay of financial institution risk and liquidity management. These techniques' benefits derive from the reduction of exposure and, by implication, counterparty risk, and from enhanced liquidity and prevention of contagion, subject to certain preconditions.

The financial crisis of 2007 illustrated that effective recovery and resolution measures require contractual stability. The risks are, *inter alia*, that early termination of transactions, which can leave

both solvent and distressed parties exposed to risks and unable to manage liquidity, could lead to further strains on distressed financial institutions. Such strains can cause financial institutions to rapidly sell their long-term assets to absorb losses leading to a depression of the asset values. Financial contracts also form an essential part of the interbank market, and can propel shocks to related financial institutions, thus creating a domino effect. This development can, in the worst-case scenario, adversely affect financial stability.

It has therefore been proposed to, amongst others, impose suspensions and stays on the enforceability of close-out netting and related enforcement rights. This would allow resolution authorities to stabilise the distressed financial institution or its critical parts with a view to preventing contagion. However, general or partial prohibition of close-out netting would negate its benefits, with adverse consequences for financial markets and the economy. In particular, for close-out netting to work most efficiently, there needs to be clarity and certainty concerning validity and enforceability.

The Banking Act 2009 confers unprecedented, invasive powers to intervene in contractual rights. These powers can be exercised before the commencement of conventional insolvency proceedings. These powers include write-down of equity and liabilities, or conversion of liabilities into equity, but also transfer of shares and property of the distressed financial institution to a third party. Financial contracts and close-out netting arrangements are not exempted from this regime; however, they are subject to various safeguards.

7.2 Resolution

The Banking Act 2009 was a appropriate response to the financial crisis of 2007. It has not derived from the EU Bank Recovery and Resolution Directive, but has been amended and complemented to comply with EU obligations. Thus, it is uniquely positioned and underpinned by guidelines and principles, which are distinct from other EU regimes. The preferred resolution measure is the transfer measure, in particular to a private sector purchaser as this will dispense with public funds. Bail-in and intervention in contractual rights are only ancillary measures.

7.2.1 Objective

The Banking Act 2009 serves the overarching objective of promoting and protecting financial stability. This is a departure from the conventional understanding of regulation and insolvency. The focus has migrated to the preservation of functions, systems and infrastructures, away from rescuing distressed financial institutions. This means a reorientation of risk allocation and requires a shift away from private agreements to a more encompassing regime exercised by the BoE.[1] Somewhat inadvertently, it has established a rescue culture that warrants interference with private contracts, such as the master agreements.

As will be seen below, the regulatory concepts and objectives have evolved. The following subsections reflect on the pre- and post-crisis implications for the laws, rules and regulations

[1] See Gerry Kounadis, 'Striking the correct balance between imposing a suspension of close-out netting rights while preserving legal certainty and market integrity in view of the Bank Recovery and Resolution Directive 2014/59: Part B (2015) 30(5) Journal of International Banking Law and Regulation p. 276

governing financial contracts, from the novel perspective of systemic stability. Before the financial crisis, the legislative promotion of close-out netting was widely encouraged in Europe. This promotion was predicated on a micro-prudential understanding of systemic risk. Since close-out netting mitigates credit risk, it was believed that, by permitting financial institutions to efficiently control their risk, the overall risk posed to the banking system was reduced. An additional benefit was that it also required less onerous regulation, with benefits accruing to market participants and the economy, while saving public funds.

7.2.1.1 The experience of the financial crisis of 2007

During the financial crisis of 2007 it was recognised that systemic stability is not the aggregate of the stability of single institutions, but is also conditional on their interaction. The financial crisis showed that the micro-prudential understanding was flawed, particularly because failures of financial institutions are inevitable:

> A bank failure can produce a much wider spectrum of negative consequences than the failure of a non-financial enterprise. A bank's inability to execute payment instructions may disrupt the operation of payment and securities settlement systems. It may be a direct source of significant losses to other market participants and may negatively affect the interbank market and liquidity in the banking system. Moreover, most bank liabilities are owed to a large group of depositors, many of whom are individuals who are unable to mitigate the risk or to bear the loss. Although a deposit insurance scheme may help protect depositors, it transfers the underlying costs to the deposit insurer and, indirectly, either to the state treasury or the rest of the banking industry. Finally, the interruption of transactions, the transmission of losses to counterparties and the resulting loss of public confidence in the banking sector that a failure can produce may all converge to trigger a systemic crisis, jeopardising otherwise healthy banks and disrupting the intermediation functions of the financial systems.[2]

This quote encompasses two separate elements. First, a crisis management regime should envisage the continuation of functions vital to the banking system and the economy at large. It must preclude the use of public funds. Second, it must reduce early termination of essential transactions. The quote also refers to the transmission of losses, yet this has not received due consideration in the policy debate leading to current reform. In particular, given the sizeable transactions, financial contracts have seemed a suitable source for the funding of resolution measures. In other words, while early termination may preclude the rehabilitation of distressed financial institutions, the claim that it may cause contagion has been proven to be overstated. Thus, intervention should be conditional on the rehabilitation or continuation of the systemically relevant functions, whereby the transactions are also continued. This implies that intervention to mitigate losses or to fund resolution measures is disproportionate.

The conjecture claiming that the enforcement of collateral aggravates the distress of financial institutions is misleading. The collateral provider ceases to have any beneficial interest in the collateral. However, the fact that margin calls may require the distressed party to post additional collateral is in line with the conjecture. These calls aim to reflect the increased credit risk and constitute a reasonable measure to reduce that risk.

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[2] International Monetary Fund and World Bank, An Overview of the Legal, Institutional, and Regulatory Framework for Bank Insolvency (17 April 2009) para 12

Another claim is that early termination and the consequent realisation of collateral may, under certain circumstances, depress asset values. It is intuitive that the sudden oversupply will be met by a reduction in price in order to meet the constant demand.[3] Such deterioration of asset prices may further worsen the situation of the financial institution, which will receive less for its assets. Due to the urgency to meet its obligations, the options of the financial institution will be restricted. Other financial market participants holding the same or similar assets, which can serve as substitute or as financial contracts referencing to such assets, will indirectly experience distress.

While the rationale behind shift from a micro- to a macro-prudential perspective challenging the real benefits of close-out netting may bear some truth, it is submitted that the restriction of close-out netting is not a solution. In fact, it negates the benefits of close-out netting in normal times. Thus, it is crucial to understand that the above risks are of relevance in the event of severe market distress or severe threats presented by the financial institution. Only in those circumstances will there be a need to restrict the ability to exercise close-out netting rights. For now, it suffices to state that the developing financial institution recovery and resolution framework, complemented by other regulatory reform such as clearing, will mitigate the remaining risks.

7.2.1.2 Mitigating risk in the financial system

The suggested avenue is therefore to regulate enforcement of close-out netting and collateral arrangements as part of the resolution. Financial institution resolution is a novel concept. It seeks to facilitate the management of distressed financial institution pre-insolvency. In the resolution framework, the primary concern is financial stability. Consequently, it takes account of risks that credit risk mitigation techniques pose to distressed financial institutions. Resolution authorities such as the BoE have been endowed with unprecedented powers to interfere in private contracts, which also extends to financial contracts. The restriction and modification of financial contracts are ancillary powers supporting the application of the stabilisation options.

7.2.2 Effects on credit risk mitigation techniques

However, there are also restrictions on credit risk mitigation techniques. In their absence, resolution would be unfeasible. Essentially, close-out netting agreements and relevant collateral will not be split up. Certain transactions which form part of an essential close-out netting set must be continued. A carve-out of financial contracts from the Banking Act 2009 may be considered to constitute an unjustified advantage. This seemingly uncomfortable policy choice is mitigated by the ability to re-transfer the netting set to the residual institution, thereby commencing insolvency proceedings against it.

The Banking Act 2009 provides the BoE with the power to override contractual rights, including those concerning credit risk mitigation techniques. Mitigating failure requires contractual stability, such that

[3] See Espen Eckbo and Karin Thorburn, 'Automatic bankruptcy auctions and fire-sales' (2008) 89(3) Journal of Financial Economics p. 404, Viral Acharya, Sreedhar Bharath and Anand Srinivasan, 'Does industry-wide distress affect defaulted firms? Evidence from creditor recoveries' (2007) 85(3) Journal of Financial Economics p. 787; Florian Heider, Marie Hoerova, Cornelia Holthausen, 'Liquidity hoarding and interbank market rates: The role of counterparty risk' (2015) 118(2) Journal of Financial Economics p. 336; and Joshua Coval and Erik Stafford, 'Asset fire sales (and purchases) in equity markets' (2007) 86(2) Journal of Financial Economics p. 479

parties may be prohibited to terminate transactions. Any interference should be minimal and subject to the appropriate powers and safeguards. Concerning bail-in, the guiding principle of such safeguards is that, while bail-in must allow the apportionment of losses, it must be operated in a fair and predictable manner. Any disparate treatment of creditors within the same class will only be permissible if this is done in the public interest and is proportionate to the outcome. Any interference with property rights must be kept to a minimum in order to achieve the necessary goals. Proportionality should be measured with reference to the outcome of a hypothetical insolvency scenario.

7.3 Substantive rights

This section deals with substantive rights , i.e. those rights that have been devised privately and have traditionally been promoted by public policy. The overriding considerations that warrant disregarding substantive rights and the extent to which these rights are displaced by the Banking Act 2009 are discussed below.

7.3.1 The Bank of England as a risk manager

Authorities faced significant blame for not having averted the financial crisis, mismanaging intervention and, in fact, contributing to its ramifications. This background explains their new approach and their determination to act. The new resolution framework would, paradoxically, increase the pressure to act since failure would be perceived as the result of procrastination or even mismanagement. This inference or attribution of blame may be erroneous. Imperfections or limitations inherent in the Banking Act 2009 dictate the possible actions of authorities. For instance, such actions hinge on the presumption that certain parts of the financial institution can be rescued. The success of a rescue critically depends on market forces and political decisions. For instance, it is likely that during a prolonged period of severe market-wide illiquidity the BoE may require recourse to public funds, which will ultimately be a political decision. A bridge institution may also need additional funding if market volatility and illiquidity do not permit the raising of additional funds or discontinuation of the institution.

Resolution is subject to the satisfaction of strict preconditions. The exercise of stabilisation measures is exclusively guided by the regulatory objectives,[4] which restricts the disproportionate use of the novel resolution powers. A primary concern is the protection and enhancement of the stability of the financial system in one or more EEA member states.[5] This objective is incidental to the satisfaction of the second objective, namely the promotion of public confidence in the financial system,[6] including protection of depositors.[7]

4 Section 4(4)-(8) of the Banking Act 2009
5 Section 4(4) of the Banking Act 2009
6 Section 4(4)-(8) of the Banking Act 2009
7 Section 4(6) of the Banking Act 2009

7.3.2 The legitimacy of resolution measures

Whilst constituting a novel and distinct regime from insolvency and company law, its effects ought not to differ fundamentally from those of insolvency law and other English law, rules and principles.[8] Rights of creditors of distressed entities have traditionally been subject to the court's supervision. Resolution, however, requires only minimal court intervention, limited to judicial review when the results manifestly differ from insolvency.[9] Harmed creditors only have recourse to the court once the stabilisation of a distressed institution is completed. The burden of proof is with the affected creditors.[10] For creditors to gain compensation, it must be proven that the effects of the resolution measures were manifestly worse than under a counterfactual informed by insolvency law. That plea requires that the resolution authority used its discretion disproportionately. The estimate of a counterfactual is based on assumptions, thus rendering the challenge illusive. Thus, it may be submitted that the compensatory legitimacy is, primarily, only superficial. Better protection is afforded by the safeguards in financial contracts, including credit risk mitigation techniques. However, their effect is limited. This allows the resolution authority to exercise considerable discretion while serving the achievement of the overarching objective of financial stability.

7.4 The enforceability of credit risk mitigation techniques

Resolution is a somewhat mixed blessing for financial contracts. The BRRD and, by implication, the Banking Act 2009 seek to rescue the financial institution or its systemically relevant parts in order to contain systemic distress and maintain essential services. Resolution thereby ensures contractual stability. In contrast, liquidation and administration do not offer the some prospect of rehabilitation and thus ability to continue to transact. On the contrary, failure to terminate early may result in losses, considering the empirically futile efforts of insolvency.[11] The resolution regime places the resolution authority in a risk manager position by disapplying the market-devised risk allocation. Resolution is no *panacea* since it will not apply to all financial institutions and its success will be subject to various dependencies.

The proposal for the revision of the BRRD has opened the doors to further, and more intrusive, intervention powers such as the moratorium. However, its appropriateness is not undisputed. Not only does it contradict the purpose of the European regime and existing international consensus, it also threatens to reverse the market-devised infrastructure supporting the BRRD, not least with respect to the recognition of resolution measures by counterparties in third states. Consequently, the proposal threatens to undermine this essential risk allocation mechanism and the competitiveness of European financial institutions. Lack of appreciation of the inherent intricacies of the moratorium, including its function and specific characteristics, and misperception of the purpose

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8 See Kern Alexander, 'Bank resolution regimes: Balancing prudential and shareholder rights' (2009) 9 Journal of Corporate Law Studies p. 61

9 See Michael Schillig, Resolution and Insolvency of Bank and Financial Institutions (Oxford University Press 2016) p. 116 and Case C-12/03 (*P Commission v Tetra Laval* [2005] ECR I-987) para 39

10 See *Fondazione v Lehman Brothers Finance SA* [2015] EWHC 1307 (Ch) and *R (on the application of SRM Global Masters Fund LLP) v Treasury Commission* [2009] EWCA Civ 788. Both cases are discussed in Lucy James, 'Judicial review and public law rights: do they have a role in banking?' (2015) 30(8) Journal of International Banking Law and Regulation p. 464

11 See Richard Tett, 'Administration falls short: The need for contractual stability and an executory contract regime' (2012) 9(3) International Corporate Rescue p. 167

of individual stabilisation options have motivated the extension of the bail-in option to financial contracts.

The BoE is cognisant of this development and is actively cautioning against expanding powers disproportionally. Even under the current regime, it has explicitly maintained that its preferred approach is the transfer of services of systemic relevance. Arguably, the BoE, as resolution authority is the most likely body to be able to successfully execute this measure in light of the modified insolvency regimes relating to financial institutions. On balance, interference with credit risk mitigation techniques should be limited to events of market-wide distress and should only be a measure of last resort.

7.5 The moratoria proposed under the BRRD II

On 23 November 2016, the Commission published its proposal for a revised Bank Recovery and Resolution Directive ("Proposed BRRD II"). The Proposed BRRD II forms part of a greater reform package that also encompasses amendments to the prudential regulatory framework.[12] It has moreover been fiercely and widely debated during its legislative development. The most contentious matter has been the introduction of new moratoria that can be imposed before and within resolution.

This section will consider the evolving regulatory framework relevant for financial contracts and credit risk mitigation techniques as well as the anticipated amendments to the BRRD and the expansion of resolution measures with the introduction of moratorium powers.

7.5.1 Objective and prevailing deficiency

The BRRD prohibits the termination of contracts that are predicated on any recovery or resolution action. It does not, however, protect liquidity. Depositors' withdrawal rights are unaffected and for certain institutions this form of financing source is vital. Moreover, financial institutions do not hold the value of the deposits in liquid assets.[13] Depositors, the general body creditors and investors do not have visibility on the viability of the financial institution. However, regulatory intervention signals that the institution is subject to some form of distress, which can be either endogenous or exogenous. It will ensure in the process whereby stkeholders seek to reduce their exposure thereby draining the much needed liquidity. Paradoxically, corrective action can instigate a bank run that may drain liquidity. As a consequence, failure will become a self-fulfilling prophecy.The success of corrective action may prove futile.

It should be noted that the BRRD introduced the bail-in measure. This measure is also applicable to deposits which are not eligible for deposit insurance. Ineligible deposits pertain to natural persons exceeding GBP 85,000 (EUR 100,000) and to medium and large companies. Legal persons may face not only distress when failing to safeguard funds, but also legal action that may be brought by shareholders and other stakeholders on the grounds of failure to act. And there is evidence of this

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12 European Commission, Press Release IP/16/3731 (November 2016) available at http://europa.eu/rapid/press-release_IP-16-3731_en.htm <accessed 1 May 2018>

13 Matthias Haentjens and Pim Rank, 'Legal and operational segregation of securities, derivatives and cash' in Matthias Haentjens and Bob Wessels (eds) *Research Handbook on Crisis Management in the Banking Sector* (Edward Elgar 2015) pp. 366-367

development as seen most notably in the case of Banco Popular.[14] Though widely praised, the existence of deposit insurance is insufficient to avert a bank run.[15] As a result, regulatory action may serve as a signal to reduce exposure to potential failure.

On a conceptual level, a moratorium is a temporary measure which suspends any ongoing judicial proceeding, enforcement measure, and the exercise of creditor rights, including the right of termination, netting and contractual set-off.[16] It provides a grace period which permits to devise an approach to resolve distress. In case a recovery is futile, it will facilitate the transition to liquidation.

Against this background, there are two streams of argument supporting the imposition of moratoria.[17] First, from a systemic-level perspective, temporary suspension of all termination rights can prevent further deterioration of confidence and trust in the banking system.[18] A moratorium will stop irrational behaviour culminating in a bank run. As discussed above, stabilisation of a credit institution is costly and depreciates valuable assets.[19] A bank run may also be misinterpreted as signal indicating a more widespread problem in the financial sector. Second, a temporary suspension may serve depositors' and other stakeholders' interests. By preventing the worsening of distress by stopping the outflow and depreciation of assets, it can prevent that the credit institution must be wound up. Alternatively, if the distress arises from more fundamental problems, a moratorium will improve the application of restructuring measures aimed at safeguarding deposits and increase the recovery of creditors' claims.

An express objective of the BRRD II moratoria is to harmonise the use of moratoria in resolution.[20] This suggests that there are already existing provisions in certain Member States. These moratoria are, however, overridden by the Financial Collateral Directive and Restructuring and Winding-up of Credit Institutions Directive. Thus, although moratoria may be imposed, it will nonetheless be possible to accelerate or terminate, value and net transactions. However, payment of the net amount

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14 Rodrigo Peruyero, 'Spain' (2018)1(63) Journal of International Banking and Financial Law p. 63

15 Communication from the Commission to the European Parliament, the Council, the European Central Bank, the European Economic and Social Committee and the Committee of the Regions "Towards the completion of the Banking Union", COM/2015/0587 final; Nikoletta Kleftouri, *Deposit Protection and Bank Resolution* (Oxford University Press 2015); Blanaid Clarke, 'Deposit Guarantee Schemes' in Matthias Haentjens and Bob Wessels (eds) Research *Handbook on Crisis Management in the Banking Sector* (Edward Elgar 2015) pp. 346-347; Seraina Grünewald, *The Resolution of Cross-border Banking Crises in the European Union: A Legal Study from the Perspective of Burden Sharing* (Wolters Kluwer 2014) .

16 Reinhard Bork, *Rescuing companies in England and Germany* (Oxford University Press 2012), para. 10.10. and Reinhard Bork, 'Moratoria (or "stays") under the new European Insolvency Regulation' (2016) 29 Insolvency Intelligence, p. 1.

17 Tobias Asser, 'Legal Aspects of Regulatory Treatment of Banks in Distress' (2001) International Monetary Fund p. 94

18 Impact Assessment on the European Commission's proposed banking legislation package, p. 22; Tobias Asser, 'Legal Aspects of Regulatory Treatment of Banks in Distress' (2001) International Monetary Fund, p. 94. Michael Schillig, *Resolution and insolvency of banks and financial institutions* (Oxford University Press 2016) para. 8.03; Sven Schelo, *Bank Recovery and Resolution* (Wolters Kluwer 2015) p. 109; Michael Krimminger and Rosa Lastra, 'Early Intervention' in Rosa Lastra (ed) *Cross-border bank insolvency* (Oxford University Press 2011) p. 59.

19 Christos Hadjiemannuil, 'Bank Resolution Policy and the Organization of Bank Insolvency Proceedings: Critical Dilemmas' in David Mayes and Aarno Liuksila (eds) *Who Pays for Bank Insolvency?* (Palgrave Macmillan, 2004) p. 296; Tobias Asser, 'Legal Aspects of Regulatory Treatment of Banks in Distress' (2001) International Monetary Fund, p. 95.

20 Recital (20) of the Proposed BRRD II and European Commission, *Impact assessment on the European Commission's proposed banking legislation package* (SWD 2016) 377 final/2 p. 7

will be subject to the moratorium. Nonetheless, it can be ensured that, at any point in time, irrespective of the applicable regime, the obligation will never exceed the net obligation calculated in accordance with the master agreement.

7.5.2 Interaction with the existing regime

The Commission's proposal envisages two moratoria, i.e. pre-resolution and in resolution. Both have the effect of suspending any payment and delivery obligation for up to five working days, subject to amendments suggested by the Maltese Presidency.[21] The proposal as at 22 May 2017 does not preclude the multiple use of moratoria. If the moratoria are used repeatedly and consecutively, the suspension may in principle last indefinitely. Therefore, the proposal raises some concerns about the purpose of the BRRD and the interrelation with financial stability and the importance of certainty as regards the enforceability of credit risk mitigation techniques.

The proposed moratorium under Art 63(1)(n), the above measures are targeted, which means that the stay and suspension apply to a specific contract. However, the moratorium applies to all rights, unless expressly carved out. The number of days may seem insufficient, but the presumption is that by initiating the stay on a Thursday, the resolution authority can develop a plan for the distressed financial institution over the weekend. The resolution authority is thereby effectively given four days, thus minimising any repercussions for the market in the following week. A problem will occur if the supervisory authority determines that an institution is failing or is likely to fail on a day other than Thursday. A moratorium permits the resolution authority to delay any enforcement action until the weekend, thereby giving the authority more time to develop a plan.

7.5.3 Description

The draft BRRD II provides for two moratoria, which can be initiated depending on the distress experienced by the financial institution and can, accordingly, serve different objectives. In both cases, the relevant authority, i.e. the competent authority in case of a pre-resolution moratorium[22] or the resolution authority in case of a resolution moratorium,[23] is provided with injunctive relief. Although a moratorium that is declared in respect of any indebtedness constitutes an event of default under the master agreements, it will be overridden in context of the BRRD by virtue of Art 68 of the BRRD.

7.5.3.1 Pre-resolution moratorium

In the parlance of the BRRD, the pre-resolution moratorium is an "early intervention" measure which constitutes a "crisis prevention measure".[24] The primary objective is rather of an ancillary nature. It should give the competent authority sufficient time to ascertain whether the financial institution infringes or is likely to infringe the relevant laws and regulations for accepting regulated deposits or providing investment services.[25] In accordance with the draft BRRD II, Member States will have the

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21 The amendments to the Presidency proposal reduced the suspension period to three days
22 Arts 27(1)(i) and 29 of the draft BRRD II
23 Arts 63(1)(n), 63(1a) and 63(1b) of the draft BRRD II
24 Arts 27 and 2(1)(101) of the BRRD and Art 68 of the BRRD
25 See first sentence of Art 27(1) of the BRRD

discretion to also confer this power on national resolution authorities. Such a measure would facilitate the resolution authority's assessment as to whether the conditions set out under Art 32(2) of the BRRD are satisfied. Such a stay is expected to apply for not more than five business days.[26]

7.5.3.2 Resolution moratorium

If the resolution authority is satisfied that the financial institution is failing or likely to fail, it can choose to exercise its suspension power. In contrast to pre-resolution moratoria, in-resolution moratoria constitute "resolution powers" and can therefore only be imposed by the resolution authority once the precondition for the application of resolution measures have been satisfied. Although constituting a resolution measure, it must be noted that this power is merely ancillary in the strict sense and should facilitate the execution of the resolution tools. A resolution moratorium may serve to ascertain the assets and liabilities of the distressed financial institution, including a valuation in line with Art 36 of the BRRD. Such a stay is expected to apply for not more than five business days;[27] in fact, the Maltese Presidency amendments propose reducing this period to three business days.[28] However, application of the resolution moratorium will necessarily also initiate concurrent application of a stay on termination rights under Arts 69 to 71 of the BRRD. Enforcement and termination are thereby precluded notwithstanding the discontinuance of payment and delivery obligations, including the posting of collateral.

7.5.4 Consequences

The merits of the moratorium power must be balanced with its (inadvertent or unintended) consequences. These consequences will not only materialise if the relevant measures are launched. Participants in financial markets also have to account for the potential application of a moratorium to their counterparties, thereby affecting their transaction and relationship before the potential application. Both kinds of implications are discussed in the subsections below.

7.5.4.1 Before the moratorium

The "margin period of risk" ("MPOR") is the period from the last exchange of collateral with a defaulting counterparty until the transactions are terminated or the hedges re-established.[29] For certain assumed periods it is an estimate of the additional collateral that is required to cover any shortfall, namely the independent amount or initial margin.[30] The Risk Mitigation Regulatory Technical Standards ("Risk Mitigation RTS")[31] stipulate an MPOR of ten days.[32] This period follows globally agreed standards and considers the financial institution resolution framework.[33] It has moreover been used by the market to develop methodologies for calculating the initial margin

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26 Art 29(a) of the draft BRRD II
27 Art 63(1a) of the draft BRRD II
28 Art 61(1a) draft BRRD II (as amended by the Maltese Presidency)
29 Article 272(9) of Regulation (EU) No 575/2013
30 Or the initial margin if the derivative is cleared
31 Regulation (EU) 2016/2251 of 4 October 2016 ("Risk Mitigation RTS")
32 Art 15(1) of the Risk Mitigation RTS
33 Requirement 3.1 of the Basel Committee on Banking Supervision and the Board of the International Organization of Securities Commissions, *Margin requirements for non-centrally cleared derivatives* (March 2015) available at https://www.bis.org/bcbs/publ/d317.pdf <accessed on 23 April 2015>

requirements.[34] A suspension of only two additional days results in an MPOR of 12 days. It will require a recalibration of the methodology in relation to European financial institutions. Thus, EU financial institutions are penalised with comparably higher initial margin requirements.

Thus, by prolonging the expected lapse of time, the transaction cost increases. It is also conceivable that, due to change in the corresponding obligation, the collateral becomes orphaned, which may increase losses. Consequently, financial institutions are less likely to transact with financial institutions that are likely to be subject to resolution or if downgrade triggers prompt heightened payments of the independent amount.[35] Besides reducing access to hedging or increasing its cost, heightened requirements for collateral also affect the liquidity of posted assets.

It is argued that the global perception of the validity and enforceability of credit risk mitigation techniques is tainted as a result of such uncertainty. Foreign market participants are therefore less inclined to transact with institutions subject to the BRRD. Such competitive disadvantage weakens not only financial institutions but also the economy at large since multinational enterprises will encounter problems in obtaining the the financial services required for executing and securing their operations. At present, it is presumed that the short stay and suspension do not affect the recognition of credit risk mitigation arrangements for the purpose of regulatory capital under the CRR. The intrinsic uncertainty arising from the proposed moratorium will undermine enforceability. In the absence of amendments accordingly made to the CRR, financial institutions may also lose the benefits of netting, thus considerably increasing the risk-weighted assets and hence the capital requirements. The international dimension shall niot be neglected. Third country authorities may also not permit their supervised institutions to transactio with EU institutions on a net basis.

7.5.4.2 During the moratorium

Given that payment and delivery obligations are suspended, while the underlying obligation of the financial contract is developing unconstrained, the exposure will change. However, the suspension will result in the exposure becoming potentially uncollateralised. In case the moratorium can be imposed multiple times consecutively, thereby potentially exposing both parties to indefinitely to market flactuations. For instance, if the non-defaulting party used the transaction as a hedge, it will need certainty as to whether it must rebalance its position by entering into a substituting transaction. However, without prior termination, there is a risk that the suspension will be lifted, whereby suspended payments become due while simultaneously payments and deliveries will have to be made to the new counterparty.

7.5.4.3 Source of systemic risk

The purpose of the EU netting legislation is to promote confidence in financial markets and stimulate integration. By creating a market that is vast and has diversified participants, its resilience is strengthened. Netting legislations' objective therefore is beyond promotion of financial stability. Exposing financial institutions to market volatility and other risks for a prolonged period of

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34 International Swaps and Derivatives Association, *Standard Initial Margin Model for Non-Cleared Derivatives* (2013) pp. 6 et seq available at https://www.isda.org/a/cgDDE/simm-for-non-cleared-20131210.pdf <accessed 23 April 2018>

35 Or the initial margin if the derivative is cleared

uncertainty, together with the inherent uncertainty risk undermines this framework. The Financial Stability Board did not intend these potentially disastrous consequences. In fact, the global consensus is that suspension can be imposed for short periods of time only and on the strict condition that the substantive obligations will be continued.[36]

[36] Financial Stability Board, Key Attributes of Effective Resolution Regimes for Financial Institutions (2011 as amended in 2014) Key Attribute 4.3

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