Further discussion of legal uncertainty which could arise from bail-in: an addendum to the FMLC paper entitled *Observations on legal uncertainties which may arise from the introduction of bail-in powers*
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1 The FMLC paper can be accessed at [http://www.fmlc.org/Pages/papers.aspx](http://www.fmlc.org/Pages/papers.aspx).

2 Joanna Perkins and Roland Susman.
1. Introduction

1.1. The role of the Financial Markets Law Committee (the “FMLC” or the “Committee”) is to identify issues of legal uncertainty or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks, and to consider how such issues should be addressed.

1.2. In March 2012, the FMLC published a paper entitled *Observations on legal uncertainties which may arise from the introduction of bail-in powers* (the “FMLC Paper”).

1.3. The FMLC Paper makes a number of general observations regarding legal uncertainty and bail-in. It provides an analysis of the effect of bail-in on different classes of creditor and claim and raises further general difficulties associated with a bail-in power. The Paper considers, in particular, issues which arise from the UK Government’s response to the final report of the UK’s Independent Commission on Banking.  

1.4. The FMLC Paper argues that legal certainty is promoted where narrow policy objectives are implemented by tightly defined statutory or regulatory powers. The Paper suggests that a bail-in power would, therefore, benefit from the clear delimitation of the specific classes of claim to which it applies.

1.5. The purpose of this addendum is to provide further detail on the problems of legal uncertainty posed by bail-in in light of a discussion paper regarding such powers from DG Internal Market and Services. The addendum, in particular, develops the analysis of classes of creditor and claim, with respect

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to which the application of bail-in raises particular issues of legal uncertainty, found in the FMLC Paper.

2. Classes of creditor and classes of claim

2.1. Contingent or disputed liabilities. When a bank is requested by a customer to provide a third party with, for example, a guarantee, standby letter or bond, the bank’s liability will be contingent unless and until it receives a valid demand for payment. Ascertaining the value of such contingent liabilities could be difficult and the accuracy of any estimation could change over time.

2.2. Netting or set-off arrangements. Netting allows for multiple related claims between parties to be reduced to a single claim. The effect of the application of bail-in to a liability falling within a netting arrangement could, therefore, be to undermine the overall arrangement. A counterparty could, as a result of bail-in being applied, be left owing a gross sum to a bank but with a much reduced or extinguished claim against the bank.

2.3. Set-off plays a central role in cash management arrangements offered to company groups by banks. The effect of bail-in on these arrangements is such that, in the event of resolution, a customer’s claim against a bank for repayment can be written down or extinguished while its liability for borrowing from the bank remains intact.

2.4. Practical obstacles stand in the way of the application of bail-in to sums after netting or set-off. Where a bank remains a going concern and has a continuing business relationship with a customer, the moment of bank resolution may be an inappropriate time to close-out netting agreements.

2.5. Establishing net values can be a time consuming process. In the context of a resolution intended to take place over, for example, a weekend this would be problematic. During the collapse of Northern Rock and Bradford and
Bingley in the UK, gross calculations were used for the support of deposits, in part, because net values could not be established in a reasonable time.

2.6. **Trade creditors.** The FMLC Paper makes the point that trade creditors are unlikely to be in a position, either in terms of knowledge or financial strength, to withstand the bailing in of a bank’s liabilities to them. The FMLC Paper also argues that the bailing-in of trade creditors could disrupt the provision of essential services to a bank and, as a result, help to precipitate its collapse.

2.7. The FMLC believes, moreover, that no trade creditor, notwithstanding the goods or services provided, should be subject to bail-in. To apply bail-in to non-essential trade creditors would require a difficult distinction to be drawn between those providing essential and those providing non-essential goods and services. A trade creditor could face considerable uncertainty as to its own status with regard to bail-in if such a distinction were to exist, not least because its status could, presumably, change over time.

3. **Further points to note**

3.1. **Group structures.** Some bail-in proposals contemplate giving bailed-in creditors equity in the bank being resolved. In the context of group structures where, for example, a bank is a wholly owned subsidiary, the shares with real value will, in fact, be in respect of a different entity (e.g. a parent company) that does not fall under the bail-in power.

3.2. **Jurisdictional limits.** Bail-in powers are likely to face barriers to enforcement in foreign jurisdictions unless there is international coordination to achieve coherence and mutual recognition. In particular, an attempt to apply a bail-in power to debt created prior to the creation of the power itself is unlikely to be successful in a foreign jurisdiction (such a retrospective use of the power may, of course, also face legal challenges in its home jurisdiction).
4. Conclusion

4.1. The FMLC’s paper entitled *Observations on legal uncertainties which may arise from the introduction of bail-in powers* makes the argument that any bail-in power should, in order to help ensure legal certainty, be narrowly drawn. The clear delimitation, in positive terms, of the classes of claim and creditor to which the power would apply is, therefore, preferable. The Paper analyses specific problems that arise in the context of different classes of creditor and claim.

4.2. This addendum has, in particular, built on the analysis of specific liabilities, in the FMLC Paper. The addendum has also commented briefly on legal uncertainties with respect to group structures and enforcement in foreign jurisdictions.
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