



The Law Society
of England and Wales

High-level Expert Group on reforming the structure of the EU banking sector

November 2012

ETI Registration number: 38020227042-38



The Liikanen report

Response by the Law Society of England and Wales

INTRODUCTION

1. The Law Society of England and Wales is the representative body of over 160,000 solicitors in England and Wales. The Society negotiates on behalf of the profession and makes representations to regulators and Government in both the domestic and European arena.
2. This response has been prepared on behalf of the Law Society by members of our Banking Reform Working Group. The working group is comprised of senior and specialist lawyers with expertise in financial services regulation, banking, competition, EU and international commercial law and economists¹.
3. The Law Society welcomes the publication of the High-level Expert Group report (the Liikanen report) and this opportunity to offer our perspective on the Group's findings.
4. The Law Society responds to this consultation as a body whose 11,000 member firms are predominantly small or medium-sized businesses, but which also include a substantial number of large internationally focused firms. The banking arrangements, funding and investment options of all our member firms would be directly affected by the proposals.
5. We also respond as a body whose members have extensive experience in giving advice on banking and financial services law and regulation to banks and other institutions, as well as businesses of all shapes and sizes and to consumers. The working group represents many members of the profession who advise in these areas and want to see effective and workable laws.
6. While the recent crisis has demonstrated a need for review and reform of the banking system to make it more stable and robust in the face of future shocks², there is also a need to ensure the banking system delivers good value for customers through competitive markets.
7. A key element of any reformed legal framework is legal certainty, which enables business and financial decisions to be made with confidence. The need for legal predictability is of particular importance in the financial sector particularly because of the very large sums of money involved and as the legal basis on which equity and debt are provided to banks must be certain.
8. It is against this background that we submit the following views to the Commission.

¹ See Annex I for full membership list.

² The causes of the crisis and ongoing difficulties are succinctly summarised on pgs 88 - 94 of the Liikanen report. Source: Liikanen, E et al (2012). 'High-level expert group on reforming the structure of EU banking sector'.

SEPARATING THE BANKS

The Liikanen proposals

9. The recently published Liikanen report discusses two options for reforming the structure of the EU banking sector.
10. In broad terms the first proposal is described as 'contingent functional separation'³, which to a significant degree is based upon utilising the recovery and resolution plans (which each bank will be obliged to produce) as the basis for separating the retail banking activities and proprietary trading and market making activities⁴. This model of separation should, it is proposed, be complemented by higher capital requirements.
11. However, the favoured option appears to be the second model i.e. the mandatory *ex ante* legal separation of certain activities (regarded as risky financial activities) from deposit-taking within the group^{5 6}. The report argues that this type of separation needs to be complemented by a number of other reforms, some of which we comment on in this response.
12. It is suggested in the report that the activities to be separated are primarily proprietary trading of securities and derivatives and '*...other activities closely linked with securities and derivatives markets...*'⁷. However, we are concerned that there appears to be some uncertainty in the exact scope recommended⁸, which could negatively impact compliance and business planning. At the same time, we note that there is an inherent tension when legislating in this way i.e. between the competing demands of flexibility and certainty. Therefore, if and when proposals do emerge they should be drafted with care, thoroughly thought through and consulted on extensively.

Is separation necessary?

13. There are genuine questions regarding the need for separation of activities at this time. We consider that the Liikanen report does not sufficiently examine the potential downsides associated with separation. We would urge the Commission before taking forward any recommendations to undertake a robust and extensive cost-benefit analysis of the impact of the proposals on the wider EU economy, individual Member States, the banking sector in the EU and consumers of banking services. A number of what we consider to be the most salient of the potential downsides are set out below.
14. There is a long list of other EU, international and national initiatives that have recently been put in place or are in the process of being implemented, which are all designed to increase the robustness of banking in the EU Member States. These include:
 - a. the Basel III arrangements;

³ This is described as 'Avenue 1' in the report and is set out on pgs 95 – 97. Source: Liikanen, E et al (2012). '*High-level expert group on reforming the structure of EU banking sector*'.

⁴ We note that the 'Future of Banking Commission' suggested a similar reform in their 2010 report, accessed at: <http://www.which.co.uk/documents/pdf/future-of-banking-commission-report-276591.pdf>

⁵ This is described as 'Avenue 2' in the report. Source: Liikanen, E et al (2012). '*High-level expert group on reforming the structure of EU banking sector*'.

⁶ The report sets out a broad outline of activities the deposit taking entity should be allowed to undertake on pg 101. Source: Liikanen, E et al (2012). '*High-level expert group on reforming the structure of EU banking sector*'.

⁷ Liikanen, E et al (2012). '*High-level expert group on reforming the structure of EU banking sector*', pg 100.

⁸ The report offers a broad outline regarding what should reside in which part of the banking group. On pg 102 of the report it is stated that the trading entity should be allowed to '*...engage in all other banking activities, apart from the ones mandated to the deposit bank; i.e. it cannot fund itself with insured deposits and is not allowed to supply retail payment services*'. It is however, not very detailed and lacks the certainty necessary for effective compliance. Source: Liikanen, E et al (2012). '*High-level expert group on reforming the structure of EU banking sector*'.

- b. the current prudential and resolution initiatives being undertaken in Member States and across the EU⁹;
 - c. the creation of colleges of supervisors¹⁰ and other enhancements to regulatory oversight¹¹; and
 - d. the work of the Financial Stability Board on systematically important institutions.
15. We are concerned that the report may lead to further complicated initiatives that require phasing in over a protracted period of time, when the current ones have not had time to become properly embedded; their effects have not had the time to work their way through the system and institutions are still adjusting their activities. Implementing too many new regulations at the same time will be complex and costly.
16. Further, it is likely that separation would lead to an increase in the costs of capital for EU banks. This may reduce the quantity of credit available and increase the price of credit for the real economy. Additional restrictions which hinder the availability of finance in the current economic circumstances would be potentially counter-productive. In particular, making both entities subject to CRR/ CRDIV would significantly increase their cost of capital and adversely impact credit creation for the real economy¹².
17. Finally, reform is likely to have an asymmetric impact on Member States. The potential differences in the consequences for Member States need to be fully analysed before specific measures are brought forward. Disproportionately negative effects on major EU and Member State industries must be guarded against.

Better than the alternatives

18. We note that there are also some national initiatives underway, which are aimed at separating the activities of banking groups¹³. A situation where there are numerous policy initiatives underway, aimed at similar ends but proposing different ways of achieving those ends, is likely to cause greater confusion and costs. The existence and the implications of this complicated policy environment have been raised a number of times in the UK by the Law Society. We did this most recently in our written evidence¹⁴ to the Parliamentary Commission on Banking Standards¹⁵, who are scrutinising the current UK proposals for ring-fencing retail banks.

⁹ At the EU level the Resolution and Recovery Directive (RRD) is being taken forward. Accessed at: http://ec.europa.eu/internal_market/bank/docs/crisis-management/2012_eu_framework/COM_2012_280_en.pdf

In addition, in the UK, the Banking Act 2009 created the Special Resolution Regime, giving powers to the FSA, HM Treasury and the Bank of England to resolve failing deposit taking institutions.

¹⁰ Associate Dean and Associate Professor of Law at the University of South Carolina, Duncan Alford, outlines the development of the idea of colleges of supervisors in relation to international banking and finance and notes that: '...the creation of colleges of supervisors for all systemically important financial institutions is an improvement in financial supervision'. However, he further points out that '...until an international regime for bank insolvency is established, colleges of supervisors can only modestly improve the international framework for financial supervision'. Source: Alford, D (2010). 'Supervisory colleges: the global financial crisis and improving international supervisory coordination', accessed at: <http://www.law.emory.edu/fileadmin/journals/eilr/24/24.1/Alford.pdf>

¹¹ In addition to the greater co-operation a number of initiatives focused on greater product and conduct regulation are being introduced e.g. PRIIPS, UCITS, EMIR etc. Further, in the UK for example, the Financial Services Bill will radically change the structure of financial services regulation and in conjunction with a change of focus by the FSA (post the Turner review) will herald a move to an approach more focused on business strategies and system-wide risks.

¹² Proposed under both reform measures examined in the Liikanen report, set out on pgs 95-99. Source: Liikanen, E et al (2012). 'High-level expert group on reforming the structure of EU banking sector'.

¹³ HM Treasury (2012). 'Banking reform: delivering stability and supporting a sustainable economy' and HM Treasury (2012). 'Sound banking: delivering reform'.

¹⁴ See Annex III for a copy of the Executive Summary of our written evidence. Law Society of England and Wales (2012). 'Parliamentary Commission on Banking Standards pre-legislative scrutiny of the draft Banking Reform Bill: Submission by the Law Society of England and Wales'.

¹⁵ The Parliamentary Commission on Banking Standards (chaired by Andrew Tyrie MP) has been tasked with examining the draft Financial Services (Banking Reform) Bill. Further information about the Commission, including membership, can be accessed here: <http://www.parliament.uk/bankingstandards>

19. In such a context the important question is to determine which of the model (or models) of separation or ring-fencing put forward are likely to be the most workable, both in terms of compliance and from the point of view of that least damaging to bank customers. We consider that if banks are to be separated then broadly speaking the division proposed in the Liikanen report is preferable to other models, which are under consideration by policy makers.

Strengths of the Liikanen proposals

20. In particular we consider that the Liikanen model for separation:
- a. allows retail banks to offer a full range of banking services to customers and will not force businesses, for example, to deal with two different institutions in order to have their banking needs fulfilled, which appears to be a likely consequence of the UK model;
 - b. avoids having some business banking activities lumped together with the so-called 'casino activities', which would negate to a considerable extent the stated policy objectives of protecting banking for the real economy; and
 - c. provides a more logical approach in the way it sees any split being imposed, by looking at the operations of a bank much more through the eyes of the customer.
21. The complexity of the policy situation is further added to by the fact that the effectiveness of uncoordinated national measures is likely to be somewhat limited in the longer-term because of single market rules e.g. action by the UK Government could put UK banks at a competitive disadvantage *vis-à-vis* EU banks which are not ring-fenced or are ring-fenced differently. We have also highlighted our concern in this regard to the UK Government¹⁶. Similar concerns can be extended to the EU in the global context.

Thresholds for splitting

22. In our view using the thresholds described in the Liikanen proposals¹⁷ as the basis on which a bank will be required to separate are likely to be more workable and require less complex rules than other models of separation under discussion. However, the Liikanen proposals still involve a certain degree of complexity. We believe there are a number of problems that will have to be properly analysed before any workable proposals are brought forward, for example:
- a. the proposal is likely to pose difficulties for banks whose business fluctuates around the thresholds. In fact it may result in some banks who anticipate passing the threshold carrying out separation far in advance of actually reaching the threshold;
 - b. the threshold is likely to act as a disincentive to expansion because of the administrative and other costs of moving over the threshold. This may impede the growth of challenger banks in particular and reduce dynamism in the sector;
 - c. it will be a significant decision and an expensive commitment if a bank does cross the threshold and subjects itself to separation. It will create expensive and extensive transition periods and there will need to be arrangements in place to manage transition;

¹⁶ Law Society of England and Wales (2012). 'Parliamentary Commission on Banking Standards pre-legislative scrutiny of the draft Banking Reform Bill: Submission by the Law Society of England and Wales'.

Law Society of England and Wales (2012). 'Banking reform: delivering stability and supporting a sustainable economy: Law Society response to the HM Treasury White Paper'.

Law Society of England and Wales (2011). 'Independent Commission on Banking: Interim Report Consultation on Reform Options – response by the Law Society'.

¹⁷ These are described on pg 101 of the report. Source: Liikanen, E et al (2012). 'High-level expert group on reforming the structure of EU banking sector'.

- d. it could be difficult to find a robust definition of 'significant' i.e. it will not be easy to devise a definition that is durable over a long period of time and that credibly captures what volume of activities are consistent with financial stability and which aren't. Further, a robust definition would have to take into account a host of other factors¹⁸, which do not appear to have been considered and which will be difficult to set down in rules; and
 - e. the two step approach to the decision on mandatory separation creates an extra layer of complexity; consideration should be given to having a simpler threshold mechanism.
23. However, despite the problems raised above, we believe the separation proposed in the Liikanen report i.e. between deposit taking on the one hand and proprietary trading and market making on the other, would be much less disruptive for customers and much more manageable than a separation dividing some ordinary banking services required by business customers from others, which the UK proposals seem to do.

CAPITAL REQUIREMENTS (LOSS ABSORBING CAPACITY)

A flexible approach to capital requirements

24. In relation to the issue of capital requirements and how they should be implemented we are of the view that, while broad limits should be set for reserve requirements/ capital there should be discretion for regulators and banks as to how they reach those thresholds, based on the circumstances of each institution.
25. Such an approach has two benefits:
- a. it brings flexibility into the system i.e. the particularities of each institution can be reflected in determining their compliance requirements. At the same time it can be an approach which maintains a degree of certainty e.g. by setting boundaries and providing clear minimum standards. In addition, certainty can be further enhanced if the requirements of the regulator are based on a clear set of principles and the specifics (including the rationale behind them) are set out clearly to the bank to which they will apply to;
 - b. it may help mitigate some of the cost impacts of higher reserve requirements. In setting rules in this area, it is important to consider the impact on the EU banking sector and the possible detrimental consequences for the competitiveness of EU banks compared to their international competitors. In particular the Commission should consider whether in time the capital requirements may drive some banks to base themselves outside the EU, in jurisdictions with less demanding requirements, or at least shift significant business out of the EU.

Impact of the proposals on different market segments

26. On the basis that all business banking is outside the ring-fence and only the largest banks are required to separate proprietary trading and market making, we do not see this as distorting competition in the provision of ordinary banking services in relation to either businesses or individuals. While treating market making and proprietary trading

¹⁸ One difficulty is that the fluctuations in markets mean it is inherently difficult to define what will be significant over a sustained period of time. Further, a comprehensive definition should also take into account:

- a. the types of business being undertaken – as some types of trading are likely to be more systematically important than others; and
- b. the interconnectedness of the relevant institution or institutions. Greater degrees of interconnectedness between institutions could mean greater systemic risk and vice versa.

separately may actually increase the number (if not the ownership) of active traders. The impact on availability of underwriting services will also need to be considered.

27. However, the impact on EU banks competing against non-EU banks needs to be clearly factored into the cost-benefit analysis. It is likely to be in this area where the competition impacts of the Liikanen proposals will be felt most keenly.

RESOLUTION AND BAIL-IN

Questions over resolution regimes

28. We do not agree that for a credible RRP, there would be a need for separation other than as proposed. In particular, it is important that businesses can access the full range of banking services for domestic and international business on one side of the ring fence, which would naturally be the deposit bank side.
29. Requiring RRP to go beyond any separation already proposed creates further problems:
- a. it is likely to create an additional split in the relevant banks, thus increasing compliance costs and complexity further;
 - b. it raises questions over the robustness of the existing separation, if in a process of rescue or resolution an alternative model of separation is the one that will actually enable it to be resolved effectively or be rescued rather than the original separation imposed;
 - c. it raises serious questions about the need to impose the extra cost of the Liikanen proposals if they are not going to be very helpful at a time of crisis.

Bail-in: a number of drawbacks

30. We draw attention to our letter of 26 April 2012 to DG Internal Market, European Commission, setting out our views on bail-in¹⁹.
31. We would stress the need for legal certainty, predictability and transparency regarding the treatment of shareholders and investors in financial institutions so that they can make informed decisions on the risks associated with their investments. Otherwise there is a risk of higher funding costs and a decrease in the competitiveness of European banks.
32. Therefore, we welcome the greater clarity around bail-in that Liikanen calls for e.g. clear definitions and clarity on the position of bail-in instruments within the hierarchy of debt commitments, in other words measures to ensure a high degree of clarity for investors²⁰.
33. However, the improvements called for in the Liikanen report do not alter some fundamental concerns we hold regarding bail-in.
34. For example, there is an un-resolvable conflict between the idea of respecting the hierarchy of claims in a bank insolvency and a wide statutory power of bail-in which will inevitably involve carve-outs and exceptions.

¹⁹ See Annex II for a copy of the letter to DG Internal Market on this issue.

²⁰ Liikanen, E et al (2012). 'High-level expert group on reforming the structure of EU banking sector', pgs 103 - 104.

35. Further, we believe that bail-in should be confined to categories of debt with a known principal amount and where the holders have notice from the date of creation of the debt that the bail-in regime could be applicable. We welcome the recognition of this point in the report.
36. We are encouraged by the recognition in Liikanen that bail-in carries risks and is not a panacea for solving the inherent tension between the capital needs of a bank under stress and the need for the bank to continue to provide banking services to its customers. In fact, bail-in carries risk of contagion and can make a bad situation worse if it spreads to customers and suppliers. Indeed, during a systemic crisis bail-in can be relatively ineffective. At best it might be useful if there is a problem with one or two particular institutions.
37. We do not consider that the current RRD proposals are sufficiently clear and do not meet the principles set out in our letter to DG Internal Market on this matter. Therefore, we do not believe that bail-in in the form proposed by RRD should be adopted. We have noted the limitations on the usefulness in resolution of bail-in in the more limited form that the report recommends. It should be noted that it is a tool to address capital adequacy and does not, in itself, produce immediate cash-flow benefits for a failing bank. Banks that are suffering a cash flow crisis are helped by bail-in only if it enables them to reconstruct their balance sheet in a way that allows them to retain and attract lenders and depositors and so maintain the ability to pay their debts as they fall due. Bail-in is only useful for banks that have the capacity to remain, in whole or in part, going concerns. Insolvency processes without bail-in are appropriate for banks that have totally failed, and insolvency processes should also apply to the assets and liabilities not transferred to a bridge bank in a partial reconstruction, which may include bail-in of debt to the capital of the bridge bank. Equity holders in that case do not require bail-in but simply to be left with their capital in the failed bank.
38. Our comments in the preceding paragraph link in to our concern at the continued support for 'universal' bail-in of unsecured creditors. We think that this is wholly impractical, not least because:
- a. outside of the categories of debt issues made with bail-in as a recognised risk, very few obligations (apart from deposits) will be of sufficiently certain amounts to make it practical to estimate (in the short term) the capital values that could be bailed in;
 - b. bail-in is only suitable where a bank (or a substantial part of it) can be rescued: if it has failed completely, insolvency rules should apply which provide a well-established basis for the sharing of asset shortfalls between creditors, normally involving total loss of shareholder's capital²¹;
 - c. where a bank has not failed completely, the business will need to preserve and carry on intact the rights and obligations comprised in its principal customer relationships on an ongoing basis. This is inimical to the application of bail-in to deposits by customers (whether or not covered by a deposit guarantee scheme);
 - d. in addition the decrease in the value (or total loss of unguaranteed deposits) would cause contagion in the wider economy: for example by cross-defaulting all debt of a business customer by placing it in breach of its overdraft or overall exposure limits;
 - e. in relation to any derivatives (foreign currency or interest rate hedging arrangements) provided to customers, close-out would be necessary in order to find a value to be bailed in. This would also carry contagion risks and be inconsistent with preserving the ongoing relationship;

²¹ The circumstances where ultimately creditors are paid in full and shareholders receive a dividend after a company has been declared insolvent are very rare: this happened in the case of Rolls Royce PLC which was declared insolvent in 1971 but the liquidators after the successful sale of viable parts of the business ultimately paid creditors in full and returned some capital to shareholders.

- f. suppliers to the ongoing business will have rights to terminate their contracts if not paid in full. This is not compatible with all or part of the bank continuing as a going concern. There is a limit to how far regulation can force supplier's owed very large sums of money to continue supply, especially in cases where a failed bank is a major customer of the unpaid supplier.

TREATMENT OF RISK

- 39. One or two issues appear for the first time in this report. We comment on a couple of issues which we consider to be important.

Real Estate Funding

- 40. In our view this is an issue that is best dealt with by Member States. Economic recovery will involve restoring health to real estate markets particularly in countries such as Ireland and Spain, where imbalances in the property market have underlain the banking crisis²². However, the position varies widely from country to country. In the UK, for example, contraction in real estate purchases and development funding (both for domestic and commercial property) has been recognised as holding back growth²³ and contributing to a housing shortage and weak construction industry²⁴. On the other hand, Spain and Ireland appear to have surplus housing stock²⁵.
- 41. This type of divergence between Member States is indicative of a matter that is perhaps best tackled at a domestic level, where very different situations can be tackled with appropriate measures. It would be very difficult to have rules in this area which could both apply equally across all Member States while taking account of the diversity of situations within each Member State.

Exposure Rules

- 42. The Liikanen report suggests that the case for further restrictions on exposure should be re-examined and implies that they may need to be tightened²⁶. While we understand the desire to limit exposure of one part of a banking group to other parts of the banking group, in times of crisis we would urge caution in relation to further restrictions on exposure rules for three reasons:
 - a. tighter limits on exposures within banking groups, other than the large exposure rules (which will apply automatically where there is structured division of activities in separate legal entities) are likely to produce perverse incentives;

²² Liikanen, E et al (2012). 'High-level expert group on reforming the structure of EU banking sector'.

²³ The direct and indirect macro-economic contributions of housing activity accounted for a third of the 6% fall in UK GDP during the recession caused by the financial crisis. Source: Regeneris Consulting and Oxford Economics (2010). 'The role of housing in the economy: a final report' in Confederation of British Industry (2011). 'Unfreezing the housing market', accessed at: http://www.cbi.org.uk/media/1157544/cbi_unfreezing_the_housing_market_november_2011.pdf

²⁴ The CBI suggests that housing activity accounts for 17% of construction industry output and 3% of GDP in the UK. The CBI has further noted that 335,000 jobs in the UK are directly dependent on the housing sector and also highlights the positive correlation in the UK between house prices and consumer spending. Source: Confederation of British Industry (2011). 'Unfreezing the housing market', accessed at: http://www.cbi.org.uk/media/1157544/cbi_unfreezing_the_housing_market_november_2011.pdf

²⁵ Williams et al note that 17% of Irish housing stock is empty. Source: Williams, B. et al (2010). 'Managing an unstable housing market', UCD Urban Institute Ireland Working Paper Series, accessed at: <http://www.businessandfinance.ie/files/UCD%20housing%20report.pdf>

²⁶ The suggestion can be found on pg 105 of the report. Source: Liikanen, E et al (2012). 'High-level expert group on reforming the structure of EU banking sector'.

- b. exposure rules which are too restrictive may act to prevent banking groups pulling together in the face of problems, potentially leaving those entities experiencing difficulties more exposed, to either sink or swim on their own; and
- c. if one part of the banking group is too limited in its dealings with the other part (including the possibility of giving or receiving emergency funding) by the large exposure rules, or other exposure restrictions, it might encourage these groups to consider exiting retail banking or encourage mergers within Member States and across the EU, diluting competition creating a more concentrated banking sector.

CORPORATE GOVERNANCE

Robustness of the existing framework

- 43. We have stated previously, in response to HM Treasury in the UK²⁷, that specific new arrangements for corporate governance are largely unnecessary. Current law (largely derived from EU law) is likely to be sufficient to ensure any separate business entity under any separation proposals is run as independently as any other business entity. There are both company law and financial services rules for responsible individuals (e.g. company directors) which address this concern and duplication of rules in slightly different language is both confusing and unnecessary. Similarly, the financial services regime provides appropriate sanctions for any individuals in senior positions within banks who do not follow these rules.
- 44. Thus, while we agree that it is important to have strong corporate governance rules and appropriate sanctions, we believe that, on proper examination of existing rules, they already cover the points raised in discussion of this issue.

²⁷ Law Society of England and Wales (2012). 'Banking reform: delivering stability and supporting a sustainable economy: Law Society response to the HM Treasury White Paper'.

Annex I: Banking Reform Working Group

Membership

Dorothy Livingston (Chair) – Herbert Smith LLP
Charles Morris – Clifford Chance LLP
Chris Moss – JMW LLP
Greg Olsen – Clifford Chance LLP
Jennifer Marshall – Allen & Overy LLP
Karen Anderson – Herbert Smith LLP
Mark Clough QC – Brodies LLP
Mat Hughes – Ashurst LLP
Michael McKee – DLA Piper LLP
Patrick Buckingham
Penny Sanders – Wragge & Co LLP
Philip Wood QC – Allen & Overy LLP
Simon Currie – Covington and Burling LLP
Temi Akinrinade – Ashurst LLP

Annex II: letter to DG Internal Market

Mr Hannes Huhtaniemi
DG Internal Market
Commission of the European Union
Brussels,
B-1000
Belgium

26 April 2012

Dear Mr Huhtaniemi,

Re: Working Document of the European Commission, DG Internal Market, on bail-in as a debt write-down tool

I am writing to you today in support of the Response to the working Document submitted by the City of London Law Society, on 20th April 2012. I write on behalf of the Law Society of England and Wales (EU Interest Representative Register ID: 38020227042-38).

The Law Society is the representative body of over 140,000 solicitors in England and Wales. The Society negotiates on behalf of the profession and makes representations to regulators and Government in both the domestic and European arena. This response has been prepared on behalf of the Law Society by members of our Working Party on Banking Reform. The working party is made up of senior and specialist lawyers and an economist, with expertise in banking and financial services regulation, competition law, EU law and international commercial law.

The Law Society of England and Wales supports the Commission's stated objective of ensuring that regulatory authorities in Member States have the necessary resolution tools to take effective action when banks get into financial difficulty and to help minimize disruption to markets and economies. We would welcome the development of mechanisms which achieve this aim and ensure the continuity of essential financial services for consumers and businesses.

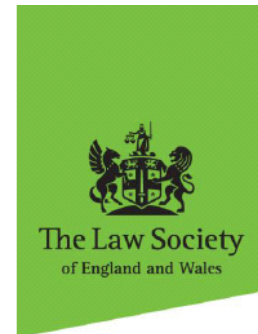
Accordingly, we appreciate the publication of the Commission's discussion document on the appropriate rules for the operation of bail-in as a mechanism for enhancing stability in the financial system.

The Law Society has not prepared a full response to this discussion document. Instead, we are writing in support of the response submitted by the City of London Law Society (CLLS). In this response paper, the CLLS raises a number of important points about the principles and practicalities of bail-in.

The Law Society of England and Wales concurs with the general view of the CLLS that the key guiding principles should be certainty and clarity in the law, together with the principle of freedom of contract¹. The Law Society is of the view that any tool which may interfere with the ability of banks and their funders to agree the terms on which they deal requires the strictest safeguards and protections, so that (i) investors and counterparties cannot be taken by surprise, (ii) funding is correctly priced and (iii) the rule of law is effectively respected. Thus if the regulatory aim is that a certain percentage of a bank's liabilities should be capable of conversion into equity (subject to bail-in) in the event that the bank gets into financial difficulties, that bank should be free to achieve that target in a consensual matter, eg through defined securities issued, and/or defined deposits

¹ CLLS comments, paragraphs: 5, 68 and 69.

113 Chancery Lane London WC2A 1PL Dx 56 Lon/Chancery Ln
t: +44 (0)20 7242 1222 f: +44 (0)20 7831 0057
www.lawsociety.org.uk



accepted, on terms that allow for bail in. The regulatory aim should not be achieved by giving regulators powers of conversion over all the bank's liabilities subject to exceptions of uncertain scope.

In the light of these more general comments, we therefore agree with the CLLS suggestion that the range of liabilities which can be 'bail-inable' should be defined clearly and limited to suitable classes of liability, where the value of the liabilities can be readily ascertained. This more limited application of bail-in is to be preferred over a wide ranging approach covering all liabilities (with a limited number of exemptions). We take this view not only for the principled reasons set out above, but because of the impracticalities of having a wide-range of liabilities subject to 'bail-in'. We consider the CLLS response paper to make this point powerfully. A bail-in policy which is limited in its nature, and which is clear on the liabilities to which it applies, is far more workable and much less complex than a less discriminating approach. In particular the Law Society shares the views of the CLLS with regard to the list of liabilities set out in the CLLS response to Question 3 of the discussion document. We would respectfully urge the Commission to consider carefully the arguments made by the CLLS in relation to each of these liabilities.

The Law Society also supports the suggestion in the CLLS response that it must be clear from the outset whether a particular liability is likely to be subject to 'bail-in'. This clarity is in our view absolutely fundamental to the requisites of the principle of legal certainty. Liabilities subject to compulsory bail-in will be more risky than those which are not. The increased uncertainty associated with a bail-inable liability will increase the risk premium which all creditors require when they deal with banks. This will in turn lead to higher funding costs and reduce the competitiveness of affected banks and their groups, as compared with those whose principle operations are outside the EU. The costs of an over-inclusive approach will be borne by EU economies as the costs incurred by banks will feed through to customers. In addition, there is an increased risk funds will be less available generally, and in particular that the increasing reality of the risk of actual bail-in will lead to a flight of funding from any evidently weakening bank and precipitate an avoidable and unnecessary crisis with its accompanying loss of confidence for the whole banking sector.

In addition, the discussion document does not appear to give sufficient coverage to the danger that bail-in could lead to distortions in the market for bank debt. Bail-in could alter the relative prices of different kinds of liabilities and thus produce a disincentive to some institutions from making decisions which would otherwise be wholly appropriate. We take the view that the longer-term effects of bail-in should be examined more closely before any concrete proposals are put forward.


We share the view of the CLLS that any reforms need to be international, rather than simply confined to the EU. Some agreement under the auspices of the G20 (or similar) would ensure as level an international 'playing field' as is practical. As noted above, the introduction of bail-in could increase financing costs for banks. Increases in such costs would, over time, have an impact on their international competitiveness, and on consumers at home. In turn, this would be likely to have a negative effect on the long-term growth rate of the financial services sector, which would have a knock-on effect on growth rates in the EU. A consistent policy across the major advanced and emerging economies is therefore important. Such an approach would help minimise any potential negative impact, from the introduction of a bail-in scheme, on the business activities of Europe's international banks.

We also concur with the CLLS that a margin of discretion for the parties concerned is key when it comes to how banks meet their reserve requirements, and their ability to absorb losses in general. The Law Society considers that while regulators should set the minimum requirements in respect of banks' loss absorbing capacity, it should be up to the banks themselves to decide what mixture of tools is most appropriate for them (including potentially voluntary bail-in which would be agreed with those providing the bank debt in question). This view is slightly different from that taken by the CLLS in answer to Question 5(a) of the discussion document.

Page 2 of 3

Although this letter is necessarily brief, I felt that it would be worthwhile taking the time to write to you in order to indicate the Law Society's support for the important points made by the CLLS and too emphasise the importance of considering fully the risks and costs of compulsory bail-in. Furthermore, the Law Society looks forward to contributing in greater detail, in the future, to the ongoing debate over banking reform.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Mark Stobbs', is written over a faint, circular embossed seal of the Law Society of England and Wales.

Mark Stobbs
Director of Legal Policy, The Law Society of England and Wales

Page 3 of 3

Annex III: Executive Summary of the Law Society's written evidence to the Parliamentary Commission on Banking Standards

1. The Law Society of England and Wales is the representative body of over 160,000 solicitors in England and Wales. The Society negotiates on behalf of the profession and makes representations to regulators and Government on both the domestic and European arena. This response has been prepared on behalf of the Law Society by members of our Banking Reform Working Group. The group is comprised of senior and specialist lawyers with expertise in financial services regulation, banking, competition, EU and international commercial law and economists.
2. The Law Society welcomes the call for evidence and this opportunity to offer our perspective.

EU and international developments: a danger of regulatory complexity

3. In our submission we argue that there are a number of dangers in 'front-running' parallel EU and international proposals, which may result in a complex set of overlapping regulations.
4. The main danger with 'front running' or implementing UK proposals that are significantly out of step with any EU proposals (which may apply to the UK) is that UK banks may end up effectively divided into three, complying with two ring-fence regimes.
5. The reliance on a significant amount of secondary legislation makes it unclear how the UK regime may or may not work effectively alongside any EU rules in this area.

Impact of the ring-fence on customers and UK bank competitiveness

6. A further danger is that the model of ring-fencing the Bill and the recent White Paper appear to propose does not work 'with the grain' of customer needs. There is a risk that the ring-fence will cut across important banking services and negatively impact the ability of UK retail bank to offer comprehensive one-stop services for UK customers and for UK businesses to easily access the products and services they need e.g. for international trade.
7. Consequently, we believe the ring-fence proposals could have a negative impact on the competitiveness of the UK banking sector. EU banks, who do not face the additional costs and restrictions of a ring-fence, will be able to passport into the UK banking sector and offer the comprehensive banking services UK banks might no longer be able to. In time this may lead to increased systemic risk, as the UK loses regulatory oversight over a number of the institutions providing banking services to the UK economy. Such moves would expose customers to non-UK depositor protection.
8. Indeed, the way the ring-fence may fall could result in the 'casino operations' being mixed up with some business banking operations. An outcome that would appear to run counter to the aims of the policy.
9. We believe the various Impact Assessments to date have failed to adequately quantify the impacts on different groups of customers
10. Further, we believe using the ring-fence as an additional tool for consumer protection should be avoided. Such objectives we believe are better suited to the new planned

regulatory framework and the range of conduct of business initiatives emerging from various quarters, such as the FSA.

Competition in retail banking

11. We see little evidence so far, in the various consultations, that there has been much consideration of the longer-term impact of the ring-fence on competition.
12. We believe the proposals could lead to a number of negative effects on competition in retail banking. These include:
 - a. the adverse effect on the incentives to enter the retail banking market;
 - b. create barriers to expansion by challenger banks, beyond a certain size;
 - c. the exposure restrictions which might encourage some groups to consider exiting retail banking in the UK or lead some to merge with other ring-fenced banks, or to consider restructuring to transfer business to subsidiaries regulated elsewhere in the EU
 - d. the activity restrictions, which could impact negatively on product innovation and product availability, especially for smaller businesses;
 - e. increased cost pressures which could mean job losses and branch closures.
13. In addition, the proposals could mean UK ring-fenced banks become very undesirable investment prospects. Their business models (may over time) become narrowly focused, resulting in restrictions in the ability of banks to access sufficient liquidity during 'stressful times'. This may mean increased riskiness, both systemically and for individual institutions.
14. In our evidence we also raise the possible impact on retail groups e.g. Marks and Spencer or Tesco who currently provide certain types of banking services, combined with insurance and other services, to their customers. It appears to us that in some circumstances these types of operations may be caught within the ring fence.
15. Further, depositor preference and bail-in (applicable to a range of liabilities) in conjunction with significantly increased reserve requirements will cumulatively add to the cost of capital for ring-fenced banks. Creditors for example will likely have to factor in a greater risk premium when contemplating providing funds for such institutions, because in the event of insolvency their money is likely to be used either to compensate depositors and/ or be 'bailed-in'.

Use of secondary legislation

16. We are also concerned about the uncertainty created by the reliance on the proposed extensive use of secondary legislation, in the draft bill.
17. While we recognise the usefulness of flexibility, especially if it enables the UK to adapt its ring-fence model in light of future EU developments, we are concerned that the minimal framework set out in the draft bill leaves too many unanswered questions, prolongs uncertainty and thus inhibits planning and compliance.
18. We are concerned that the use of secondary legislation may mean the ring-fence rules become too detailed. This could mean significant complexity and result in avoidable costs being imposed on banks. We believe there is a case for the legislation to set down purposive rules, which will govern the operation of the ring-fence across all banks and to

let the regulator agree the details of the ring-fence, so as to make sure it fits the circumstances of each affected bank.

Unintended consequences

19. The draft bill and reliance on a number of pieces of secondary legislation to 'fill the gaps' could lead to some unintended consequences. In particular we note that the White Paper proposed a system of preventing ring-fenced banks from undertaking major contracts in non-EEA laws. This could have a number of negative knock-on effects for the UK legal services sector in general and in particular, for English law as a UK economic asset and a valuable public good. We urge the Government to examine more proportionate alternative policy measures to reach their policy goals and avoid unnecessary damaging spill-over effects on other sectors.

For further information, please contact:

Carolyn Thurston Smith

International Policy Assistant (EU)
The Joint Brussels Office of the Law Societies
85 Avenue des Nerviens, Box 10
B-1040 Brussels, Belgium
Tel (+32 -2) 743 8585
E: mail: Carolyn.thurstonsmith@lawsociety.org.uk
<http://lawsociety.org.uk>