

# *The Dunfermline Building Society*

*a local problem resolved by powers  
inspired by a global financial crisis*

The Banking Act 2009 has caused concern in many quarters due to the wide powers it confers on the Bank of England, the Financial Services Authority and HM Treasury. It has now been used for the first time.

On 30 March 2009, HM Treasury announced that the Dunfermline Building Society's retail and wholesale deposits, branches, head office and originated residential mortgages (other than social housing loans and related deposits) had been transferred to the Nationwide Building Society. In addition, HM Treasury announced that the Dunfermline's social housing portfolio had been placed into a bridge bank, wholly-owned by the Bank of England, and a court order had been made to place the remainder of Dunfermline's business into the Building Society Special Administration Process.

These actions were the first ever taken under new powers reserved to the Bank of England under the Banking Act 2009 (the "**Act**") and related secondary legislation, barely one month after those powers reached the statute book. This is a timely reminder that the powers under the Act are now available for use by the Bank of England, the Financial Services Authority and HM Treasury (the "**Tripartite Authorities**") and that the Tripartite Authorities will not be afraid to use them without delay in suitable cases. How might such action affect you?

## **The Banking Act 2009: the Special Resolution Regime**

- The Act gives the Tripartite Authorities a number of extensive powers if a financial institution to which it applies is considered to be failing, which may affect the rights of that bank's shareholders, creditors and others (the "**Special Resolution Regime**").
- The Special Resolution Regime applies to UK-incorporated financial institutions which are permitted under Part 4 of the Financial Services and Markets Act ("**FSMA**") 2000 to undertake the regulated activity of accepting deposits (referred to in this note as "UK banks"). The Act applies (with certain modifications) to building societies.
- One of the main points to note is that the Special Resolution Regime allows for partial property transfers from failing UK banks, which may be of concern if any reliance is placed on set-off or netting positions, or more generally where to make such a transfer would cause (or not prevent the occurrence of) loss.

## **Stabilisation**

- There are two key "stabilisation powers" under the Special Resolution Regime:
  - the shares of a failing UK bank may be transferred to a private purchaser, or to a "bridge bank" (wholly-owned by the Bank of England) or into temporary public ownership (in doing so, the rights and obligations attaching to those shares may be varied); and
  - any of the property, rights or liabilities of a failing UK bank may be transferred to a private purchaser or a bridge bank (either in total or partially).

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- These powers may only be exercised if:
  - the UK bank is failing or is likely to fail the "threshold conditions" (which are set out in Schedule 6 to FSMA 2000 and must be satisfied if a bank is to continue to be authorised by the Financial Services Authority to accept deposits in the UK); and
  - having regard to timing and other relevant circumstances it is not reasonably likely that action (other than the stabilisation powers) will be taken which will enable the UK bank to satisfy those threshold conditions.
- In addition, the exercise of the relevant stabilisation power must be necessary having regard to certain areas of public interest (for example, the stability of financial systems, public confidence and depositor protection) which are prescribed as conditions to the exercise of any one of the stabilisation powers.

### The effectiveness of transfers

- Both share transfers and property transfers may take effect despite legal or contractual (or any other) restrictions, and may alter the terms of, or extinguish, trusts and other legal rights and liabilities. The Act is drafted very broadly to give the "stabilisation options" - transfer to a private sector purchaser, transfer to a bridge bank or transfer to temporary public ownership - maximum effect.
- Under the Act a share transfer instrument or order, or property transfer instrument, may stipulate that its provisions determine whether or not "default events" (e.g. a specified event the occurrence of which may give a right to terminate) in relevant agreements with a UK bank continue to apply. This means that, if stipulated by the relevant order or instrument, a contractual counterparty to a failing UK bank may no longer be able to terminate its agreements with that UK bank even if a trigger event has occurred under the terms of its contract with that UK bank. In the Dunfermline property transfer instrument, the Bank of England had no hesitation in providing that the transfer to the Nationwide must be disregarded in determining whether any default provision in Dunfermline's contracts with its counterparties applies.

### Partial Property Transfers

- There are clearly many commercial and legal issues which arise when private law rights can be transferred, modified or overridden in the manner envisaged by the Act. Much thought, in particular, has been given to the effect of partial property transfers, whereby two halves of a single banking relationship can be severed.
- During consultation, two key objections to partial property transfers were that they would undermine large-scale set-off and netting arrangements (which underpin the financial system), agreements involving security, capital market transactions, and certain key types of market contract, and enable "cherry-picking" (e.g. the transfer of assets, but not liabilities, to the new bank).
- With the aim of providing certainty in the financial markets, the government made an order (the "**Partial Property Transfer Order**") safeguarding certain transactions. The order provides that:
  - all (but not some) of the "protected" rights and liabilities under certain set-off, netting and title transfer collateral arrangements may be transferred (this definition excludes retail deposits and liabilities, contracts which do not relate solely to specific types of financial instrument (although, according to the Government, the inclusion of one "excluded" transaction in a netting arrangement is not intended to remove the protections for the remaining protected rights and liabilities), certain claims to damages and indemnities, and rights relating to subordinated debt);
  - assets subject to security may *not* be transferred separately from the secured liability and the benefit of the security;
  - all (but not some) of the rights and liabilities under prescribed capital markets transactions are to be transferred;
  - a Partial Property Transfer Order may not have the effect of modifying, modifying the operation of, or rendering unenforceable certain key types of market contract or certain default rules or other default arrangements of recognised investment exchanges or recognised clearing houses; and

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- a partial property transfer may not operate in any manner that contravenes Community law (which is aimed primarily at the protections afforded to designated systems under the Directive on settlement finality in payment and securities settlement systems).
- As regards the risk of "cherry-picking", the Government made an order (the "**Partial Property Transfer Compensation Order**") that compensation provisions must be put in place when a partial property transfer is made. The aim of such a scheme would be to ensure that no pre-transfer creditor is "worse off" than they would have been had the UK bank gone into an insolvency process. However, this order is drafted widely and the valuation of any such compensation will be extremely fact-dependent.

#### Points to bear in mind

- Any transfer of the rights of a UK bank pursuant to an exercise of the stabilisation power is capable of overriding any restriction in your facilities or other contractual documentation under which a transferring lender might have to consult with you first or obtain your consent.
- To ensure continuity of business, a share transfer instrument or order, or property transfer instrument may disapply default event provisions in your contracts with a failing UK bank, disabling your right to terminate those contracts by reason of the transfer.
- Unless your relationship with a UK bank falls within the relatively narrow ambit of the Partial Property Transfer Order, it is quite possible for a transfer to split up different rights and liabilities within a single banking relationship (for example, under a working capital facility a UK bank's right to receive repayment from you can be transferred, but its obligation to lend to you can be left behind).
- If you rely on a set-off, or netting, arrangement with a UK bank, or have secured, capital markets or other relevant transactions (as described above) with a UK bank you should revisit the terms of the arrangement to determine whether, on a partial property transfer, your rights would be protected by virtue of the provisions of the Partial Property Transfer Order (i.e. so that those rights could not be severed).
- You should consider how a compensation scheme put in place under the Partial Property Transfer Compensation Order may apply to you if a UK bank's property, rights or liabilities were to be transferred; for example, which guidelines would apply regarding the appointment of an independent valuer, which valuation principles would apply and which conditions would apply regarding the making of interim payments.

As the Dunfermline transfer highlighted, when a UK bank gets into trouble the Tripartite Authorities are likely to move extremely quickly in employing their new powers under the Act. We would be happy to assist you in reviewing any arrangements you have in place with UK banks to assess whether, if the same were to happen to those UK banks, your contractual rights would be adequately protected.

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If you would like to discuss any of the issues covered by this note, please contact any of the following members of our Banking department.

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