Financial Regulation international

Worldwide regulatory developments and their implications for the financial services industry

Treasury reclassifies sukuk under new regime

HM Treasury, the UK Government's finance ministry, brought sukuk and similar instruments within the scope of UK financial regulation. In this article, Robert Finney and Matthew Sapte of Denton Wilde Sapte LLP look at the changes.

Background

The UK Government's objectives on Islamic finance are to enhance the UK's competitiveness in financial services by maintaining the UK's position as a Western leader in international Islamic finance and to ensure that the market has access to competitively priced financial products. FSA has already authorised Islamic banks, and Islamic home finance products fall within the scope of the Financial Services and Markets Act (FSMA). But what the Government refers to as Alternative Finance Investment Bonds (AFIBs), in particular sukuk, often have not fallen cleanly within any particular existing category of regulated investment. This has created unfortunate uncertainty in the market, with the regulatory treatment of each new sukuk issue having to be considered carefully on its own merits.

Islamic financial instruments often appear to mirror the economic functions and effects of conventional financial products, but with different legal and risk characteristics. Many sukuk appear to be collective investment schemes (CIS) – a concept which is very broadly defined in the FSMA. In contrast, conventional bonds benefit from a specific exemption from the CIS definition (in a CIS Exemption Order made under FSMA). Arguably, this disparity has discouraged the use of sukuk as a source of funding for UK issuers.

Treasury and FSA consulted in December 2008 on clarifying the regulatory categorisation of sukuk and similar instruments, either by creating a new category of 'specified investment' in UK legislation specifically to cover AFIBs or by extending an existing category. They wanted to provide greater certainty to issuers, arrangers and investors, and to provide AFIBs with a regulatory treatment akin to conventional bonds where they are structured to have economic characteristics similar to conventional debt instruments. This would reduce the legal and compliance costs associated with an AFIB offering by UK issuers.

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The choices

Four options for the future regulation of AFIBs were suggested:

1. exempt AFIBs from the CIS definition, and create a new specified investment type for AFIBs under the Regulated Activities Order (RAO) – the RAO is the statutory instrument which specifies definitions of investments and activities (and certain safe harbours) under the FSMA;
2. exempt AFIBs from the CIS definition, but define them simply by reference to existing tax definitions, which have evolved over several years generally to treat sukuk as corporate bonds if they satisfy certain conditions;
3. exempt AFIBs from the CIS definition, and bring them within the existing RAO investment type of 'debentures' as set out in art 77 (being 'an instrument creating or acknowledging indebtedness'), like conventional corporate bonds; or
4. do nothing.

Responses

Respondents' views varied:

1. The overwhelming response (including responses prepared by Denton Wilde Sapte) was that AFIBs should be regulated in a manner equivalent to conventional debt securities, and Option 1 was the most appropriate way to do this.
2. Many other respondents argued that a unique regulatory definition would be preferable as not all conditions of the tax definition were relevant in the regulatory context. The use of tax-specific definitions in this context might even prove dangerous.
3. Most respondents felt that including AFIBs in the RAO category currently used for more conventional forms of debt may be inappropriate, given that AFIBs are by definition designed to be set apart from traditional instruments.
4. No one favoured the status quo, which would do nothing to address the regulatory uncertainty.

Treasury decided upon Option 1. Last October, Treasury published (along with feedback on the responses received) a draft order to amend the RAO.

Treasury's decision

In January 2010, following a brief consultation on the draft, Treasury laid the Financial Services and Markets Act 2000 (Regulated Activities) (Amendment) Order 2010 before Parliament. Subject to the approval of each House of Parliament, the changes set out in the Order were effective from 24 February. A new art 77A 'Alternative Finance Investment Bonds' is inserted into the RAO, bringing AFIBs within the scope of 'specified investments'.

To benefit from the new categorisation, AFIBs must satisfy a number of conditions which, consistent with Treasury's prior approach when legislating for Islamic financial instruments, make no reference to either the Shari'ah or the Islamic compliance of the instrument. These are therefore important factors to consider when structuring a UK sukuk.

It will be interesting to see how some of these are actually implemented in practice (for example, the requirement that the profit paid on a sukuk should not exceed (at the time the sukuk is issued) a reasonable commercial rate of return on a loan of the capital, as well as the requirement that the sukuk be officially listed in the European Economic Area (EEA) or traded on an EEA 'regulated market' or UK-recognised stock exchange). The regulatory treatment of sukuk that are more akin to equity instruments or fail to satisfy the conditions is unchanged.

In addition, the Order amends the CIS Exemption Order, so AFIBs benefit from the same exemption as conventional bonds, as well as from various other provisions of financial services regulation where it is appropriate to treat conventional bonds and AFIBs in the same way. Consequential changes to FSA rules are awaited: these may need to be more extensive than the limited changes consulted on last October.

During the financial crisis, sukuk issuance has been much reduced. In addition, statements by Shari'ah scholars and documentation exposed in the context of several defaults have created uncertainties as to sukuk holders' rights in underlying assets.

However, as the sukuk market revives, the UK government's further steps to change laws to cater for Islamic financial products may help to reduce the uncertainty surrounding the regulatory classification of sukuk that are issued, listed or traded in the UK.

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Legal uncertainty in Islamic finance

Trevor Norman, Volaw's director of Islamic Finance and Funds Group, considers the legal implications of Islamic financial institutions entering into transactions that are found not to comply with Shari'a law.

In a recent decision by the High Court in England, an Islamic financial institution established in Kuwait successfully argued that a wakala contract it had entered into with a customer did not comply with Shari'a and because the institution was prevented by its constitutional documents from entering into agreements that did not comply with Shari'a, the contract was void. The facts of this case will be discussed below, but following on from the much publicised Sukuk crisis in Dubai, and other less publicised similar defaults on Sukuk issued by companies established in the GCC over the past few years, a large question mark hangs over the future of Islamic finance and legal documentation of Shari'a-compliant structured finance transactions.

A wakala is a contract of agency in which one party appoints another party to perform a certain task on its behalf, usually for payment of a fee or commission but in some cases the investor receives only the agreed profit return; anything made above that is kept by the financial institution. In this particular case Blom Development Bank, established in Lebanon, placed US$10m with The Investment Dar Company of Kuwait under a wakala agreement. The Investment Dar failed to fulfil its obligations under the agreement and had not repaid the capital invested to Blom, nor any profit return on the investment account. The agreement was governed by English Law so Blom brought an action in the English courts seeking repayment of the capital and the agreed profit. The Court ordered The Investment Dar to repay the capital, but not the profit. However, on appeal, and following the legal arguments outlined above, the Court agreed that the wakala agreement did not comply with Shari'a and therefore the agreement was void.

I have no doubt that much will be written on the judge's ruling over the failing of the wakala agreement to be Shari'a-compliant and I am equally sure many lawyers and other advisors will be scanning the small print of such agreements in future. However, it is the ruling that where an Islamic financial institution has been established in a jurisdiction that permits institutions incorporated in that jurisdiction to avoid obligations arising from contracts that go beyond the powers in the institution's constitutional documents, that could have far reaching consequences for participants in Islamic finance transactions. Most institutions with a wholly Islamic offering will have similar prohibitions in their constitutional documents, indeed it may be required by law in their home jurisdiction that to be classified as Islamic rather than operating through an 'Islamic window' that they include these prohibitions.

Institutions incorporated in the UK and much of the western world would generally not be able to avail themselves of such a defence. The doctrine of ultra vires, as this is known, holds that if a corporation enters into a contract that is beyond the scope of its corporate powers, the contract is illegal. The doctrine played an important role in the development of corporate powers but is largely obsolete in modern corporate law. Historically, courts adopted the view that such acts were voidable rather than void and that the facts should dictate whether a corporate act should stand and over time a body of principles developed that prevented the application of the ultra vires doctrine in corporate law.

A related question arose in the 2004 *Beximco* case in which Beximco Pharmaceuticals Ltd as borrowers from Shamil Bank of Bahrain unsuccessfully argued that the 'governing law' clause of the loan agreement was inoperable as it required the application of both 'the principles of the Glorious Shari'a … and … with the laws of England' and therefore the agreement was unenforceable. The High Court and Court of Appeal in England concluded that the principles of *Shari'a* did not apply to the agreement as the inclusion in the governing law clause was intended to reflect the Bank's principles in doing business, and not as a system of law designed to trump the application of English law.

So what should investors or other parties to an agreement with an Islamic finance institution do to ensure that the agreement is upheld in the event of a dispute? They should:

1. ensure they obtain and fully review the constitutional documents of the institution with reference to national laws on ultra vires transactions, particularly those relating to Shari'a-compliant transactions;
2. obtain appropriate certificates and representations from the institution's Shari'a Supervisory Board;

3. ensure the relevant agreement includes representation and warranties that the agreement does not conflict with the institution's constitutional documents; and
4. where possible, arrange for the transaction to be undertaken through a Special Purpose Vehicle established as a subsidiary of the institution, but in a jurisdiction where it is highly unlikely that such defences to non-performance in a contract would be upheld, eg, Jersey.

Islamic finance is still recovering from the affects of the Shk Taqi Usmani's widely misreported statement in 2008 that many Sukuk were not fully Shari'a-compliant and the subsequent AAOIFI Resolution on *Sukuk*; it must be hoped that the ruling in the *Blom* case does not fuel greater distrust in transactions structured within the principles of the Glorious Shari'a.

For further information about the Islamic finance services we offer, please contact Trevor Norman (tnorman@volaw.com) of Volaw or Kate Anderson (kateanderson@voisinlaw.com) of Voisin.

Having the will to live: recovery and resolution plans for UK banks

Making a will is regarded by most individuals as a necessary irritant ranking in popularity somewhere below a visit to the dentist or doctor, forcing one to face his own mortality and to decide which deserving or not so deserving relatives should share in his hard earned gains.

Following the unprecedented instability in the global financial markets since 2007, the system-wide or 'systemic' risk (posed by the potential failure of large or complex cross-border financial institutions) was identified by regulators and legislators as one the key areas requiring better supervision, in order to prevent a similar crisis in the future.This had led to a call for banks and financial institutions to set out detailed plans or 'living wills' to seek to wind-down its operations in an insolvency scenario in a way which has the minimum possible impact on the stability of the financial sector.

Financial stability and depositor protection: strengthening the framework

In January 2008, in a consultation paper headed 'Financial stability and depositor protection: strengthening the framework' the UK's HM Treasury ('HMT') first set out the proposition that 'banks need to be adequately prepared to minimise the disruption arising from their own failure' [1].This envisaged that an appropriate regulatory response to the financial crisis would comprise two parts:

1. the introduction of a special resolution regime ('SRR') empowering regulators with the tools to resolve a failing bank in an orderly manner, and
2. a requirement that banks establish internal plans and arrangements designed to minimise the impact of their failure in the event of financial stress.

We consider below the proposals relating to the recovery and resolution plans ('RRPs') or 'living wills' in the context of the wider ongoing debate concerning the overall approach to financial regulation.

Banking Act of 2009 and the Special Resolution Regime

The UK government has responded to the banking crisis not only with a series of banking rescue and support measures but also a comprehensive review and reform of existing banking regulation. The Banking Bill was introduced on 7 October 2008 and resulted in the enactment of the Banking Act 2009, which came into effect on 21 February 2009.

The Banking Act 2009 (Part 1) implements a permanent version of the SRR, which had previously been introduced as an emergency temporary response to the credit crisis under the Banking (Special Provisions) Act 2008[2], which expired in February 2009. The SRR provides the HMT, the Bank of England ('BOE') and the Financial Services Authority ('FSA') (collectively, the 'Tripartite Authorities') with new 'stabilisation' tools to ensure the effective, orderly resolution of deposit-taking institutions, whereby they may transfer part or all of the bank's business, shares, assets, rights and liabilities (i) to a private sector purchaser (ii) to a publicly controlled 'bridge bank' (which will be wholly owned by BOE) or (iii) to temporary public sector ownership (ie, nationalisation). [3]

The Banking Act 2009 (Part 7) also authorises HMT to enact regulations to create a new 'investment bank insolvency procedure' for UK investment banks which hold client money or assets. From 11 May to 10 July

2009, HMT conducted a public consultation on its initial thoughts on the reforms which may be needed to develop effective resolution mechanisms for investment banks, in light of the deficiencies in the current insolvency regime which have been revealed from the failure of Lehman Brothers. [4] On 16 December 2009, HMT published a further consultation paper, which reflects the results of that consultation and outlines over 30 detailed policy initiatives designed to mitigate the impact of an investment firm's failure.

These initiatives include a new requirement for investment firms, to be mandated by FSA rules, to implement 'investment firm resolution plans' (ie, the investment banking component of RRPs currently being legislated in the Financial Services Bill).[5]

The Turner Review: a regulatory response to the global banking crisis

On 18 March 2009, the FSA published a comprehensive set of proposals aimed at addressing the risks posed by 'systemically important' financial institutions in the Turner Review and the associated FSA Discussion Paper (DP09/2). [6]

The proposals ranged from enhanced supervision and governance (including remuneration arrangements), regulatory capital and liquidity requirements, international coordination in the regulation and supervision of global cross-border banks (eg, by the establishment of 'colleges of supervisors' comprising the regulators from the main countries in which a bank operates), to the operation of crisis coordination mechanisms and cross-border contingency plans over such banks.

HM Treasury White Paper: reforming financial markets

On 8 July 2009, HMT published a white paper on 'Reforming Financial Markets', which focused on measures to better monitor and manage systemic risk, including, a specific proposal to require systematically important firms to develop, and submit to the FSA for approval, RRPs or living wills.[7]

HMT stated that they believed regulators had underestimated the extent of systemic risk and the system-wide implications of various financial engineering techniques and innovations. In particular, they concluded that the increasing use of securitisations and derivatives instruments by financial institutions may have inadvertently led to an increase in systemic risk by creating an increasingly complex network of inter-dependence. As a result, the failure of one large international financial institution could have severe repercussions on other institutions and even threaten the rest of the financial system as a whole, across national frontiers.

Accordingly, it was perceived as imperative that the Tripartite Authorities work together to ensure that 'all banks are adequately prepared and organised internally for their own resolution', by establishing clear contingency plans in advance of financial distress or failure to enable timely action in response. HMT stated that a bank's RRP:

- will be an integral factor in the FSA's overall assessment of the prudential risks borne by the firm, with possible bearing on its regulatory capital and/or liquidity requirements;
- should be proportionate to the size and complexity of the particular firm, and should include an assessment of how difficult it will be to resolve; and
- may necessitate revision (ie, simplification) of some firm's corporate structures, eg, by establishing clear lines between deposit-taking and other operations, so that the depositor book can be easily sold to another firm in times of failure with minimum disturbance to the wider financial system thus maintaining depositor confidence.

Feedback on the Turner Review and FSA DP09/2 and the Turner Review Conference

The FSA maintains that the UK is leading the effort by national regulators in developing RRPs and could provide the blueprint for international initiatives.

In September 2009 the FSA published its Feedback Statement (FS09/3)[8] reporting on the feedback received on the Turner Review consultation, including the ongoing debate and consideration of RRPs or living wills.

The FSA proposes in the statement that all systematically important financial institutions be required to develop and submit RRPs to the FSA for approval.

On 22 October 2009, in anticipation of the second Turner Review Conference on 2 November 2009[9], the FSA published a Discussion Paper (DP09/4) concerning large systemically important banks, including a proposal to require RRPs or 'living wills'.[10]

In DP09/4, the FSA set out three possible policy responses aimed at minimising the probability and ultimate consequences of failure for systemically important firms:

- Making systemically important firms smaller or less inter-connected (ie, less systemically significant).
  This could take the form of reducing the web of contracts between major firms and/or separating narrow banking (eg, retail) from riskier proprietary trading (ie, commercial) activities.
- Reducing the probability of failure to a very low level (far lower than for smaller, non-systemically important banks).
  This may be achieved by imposing higher capital and/or liquidity requirements or by requiring the regulatory capital to be wholly or predominantly in common equity. Where other forms of capital are allowed, they should be capable of bearing loss whilst the firm remains a going concern. The FSA has explicitly mentioned that certain hybrid instruments such as contingent convertibles (ie, contingent capital that converts into common equity if the firm's capital ratio reaches a certain threshold) would be acceptable, as they set up a 'pre-pack recapitalisation' of the firm. Such arrangements could facilitate a winding-up without exposing the taxpayers to yet more risk, thereby providing the added benefit of reducing the 'moral hazard' of government bailouts.
- Increasing the likelihood that a systemically important firm will be allowed to fail.
  The object is to put in place the conditions that would permit a range of options other than a whole bank rescue to be considered. Such options would involve imposing losses on some non-equity claims or compelling a simplification of the firm's legal structure as part of the RRP.

The Financial Services Bill

The Financial Services Bill (the 'Bill')[11] is a product of the public consultation conducted pursuant to the HMT White Paper in July 2009 and seeks to legislate the RRPs for all systemically important banks and other financial institutions in the UK as part of a comprehensive response to the banking crisis. The Bill provides, *inter alia*, for:

- creating a Council for Financial Stability ('CFS') to coordinate the actions of the Tripartite Authorities with respect to financial stability matters;
- mandating the FSA to make rules requiring all FSA authorised firms to create and maintain RRPs; and
- requiring the FSA to work with other national and global regulators towards the development of international standards of regulation and supervision.

According to the HMT's Frequently Asked Questions on the Financial Services Bill, RRPs are regarded as a 'key tool for authorities and firms to mitigate risks that individual firms pose to the system, and to promote long-term financial stability'.

The Bill was introduced to the UK Parliament on 19 November 2009 and is currently being debated. [12]

The current views of the HMT and the FSA can be garnered from the House of Commons' Treasury Committee First Special Report of Session 2009-10[13], published on 27 November 2009, which set out their respective feedback:

HMT's comments

RRPs aim to prepare firms for stressed circumstances to enhance their prospects of 'recovery' as well as for potential failure to enable an effective 'resolution' with minimal repercussions on the financial system.

The quality of a bank's RRP should have a direct bearing on supervisors' overall assessment of the prudential risks borne by the firm. In particular, the FSA should be justified in deciding whether to impose additional capital requirements on the basis of a firm's potential systemic impact. Thus, the RRPs will create regulatory incentives for firms to become less risk-embracing.

The FSA's comments

Referring to its statements in DP09/4, the FSA reiterates its support for the proposal that each bank shall prepare an RRP which is subject to regular evaluation by the BOE.

Improving bank resolution mechanisms is a vital component of financial services sector reform. At present, the lack of appropriate means by which large, complex banks can be resolved encourages complacency in these banks, contributing to the 'moral hazard'. The SRR is an important mechanism, but its usefulness is reduced because the Tripartite Authorities are not able to cope effectively with the resolution of large, complex banks due to a lack of information about how such banks are internally structured. In particular, RRPs must identify the actions that firms would need to take to enable the authorities to use the SRR tools (or for the firm to be placed into insolvency).

Furthermore, the FSA states that it intends to impose additional requirements on systemically important firms, depending on the following three categories:

1. the demonstration that they can quickly provide the

authorities with the data necessary for them to assess the resolution options;
2. an analysis of the potential barriers to the authorities' exercise of the SRR powers; and
3. an analysis of how the firm could 'unplug' itself from the payments, clearing and settlement systems, without damaging those infrastructure.

Once a firm has produced its RRP, it will be subject to review by the FSA, in consultation with the BOE. The FSA will assess the risks identified by these plans and the (recovery and resolution) actions proposed by the firm to mitigate them. For some firms, this may in turn necessitate structural changes (eg, where its existing corporate structure could hinder the implementation of the plans) and/or off-setting measures (eg, additional capital and/or liquidity requirements).

The FSA will work closely with the BOE and HMT, as well as international counterparts through the Financial Stability Board ('FSB'), in order to develop common approaches to the extent possible, whilst recognising that RRPs will need to be tailored to the local insolvency regimes in different jurisdictions.

Other indications of what the RRPs may entail

Further indications of the required elements and the mechanics of compliance with the compulsory RRPs can also be found in various official statements.

Mervyn King, BOE's Governor – 17 June 2009

On 17 June 2009, speaking at the Lord Mayor's Banquet for Bankers and Merchants of the City of London at the Mansion House (the 'Mansion House Speech') [14], BOE Governor Mervyn King proposed that each regulated bank be required to produce 'a plan for an orderly wind down of its activities' and called on banking regulators 'to work across national boundaries to identify detailed plans for how each large cross-border financial institution could be wound down'.

Paul Myners, HMT's Financial Services Secretary – 18 September 2009

In a speech at the *Financial Times* Global Finance Forum on 18 September 2009[15], HMT's Financial Services Secretary Paul Myners discussed the planned legislation (subsequently embodied in the Financial Services Bill) that will require banks and other financial institutions to draw up RRPs. While acknowledging the need for the details yet to be worked out, he outlined some of the HMT's thinking as follows:

- RRPs are more in the nature of 'pre-structured euthanasia' than 'living wills'. Systemically important firms will have to designate an internal 'undertaker' to take charge of the process. For some banking groups this will mean simplifying structures and reducing complexity.
- Banks will have to produce clear plans of 'how to reorganise or de-risk,' should they encounter financial difficulty including the disposal of residual businesses following resolution.
- In addition, RRPs will become key elements of the FSA's 'risk assessment framework and prudential supervisory processes'.

Mervyn King, BOE's Governor – 20 October 2009

On 20 October 2009, speaking to the Scottish Business Organisations in Edinburgh, BOE Governor Mervyn King asserted that deficiencies in the structure and regulation of the banking sector had been one of the two key underlying causes of the financial crisis, the other cause being global imbalances. [16]

As regards the second cause, Mervyn King called attention to the 'too important to fail' problem, which was distorting the incentives (or approaches to risks) of some banks. He outlined two possible approaches to dealing with this problem:
(i) ensuring that the probability of those institutions failing, and hence of the need for taxpayer support, is extremely low; and/or
(ii) finding a way that institutions can fail without imposing unacceptable costs on the rest of the economy.

The first approach could be achieved through better regulation (eg, higher capital requirements). Nevertheless, in a highly interconnected financial system, the failure of an important institution could contaminate the rest of the (real) economy. Therefore, the structure of the financial industry (or firms) may also need to be changed, so that the essential – or utility – services that the banks provide to the wider economy are insulated from their other activities.

As he had argued in his Mansion House Speech in June, the BOE Governor reiterated that regardless of the approach adopted, financial institutions should be required 'to plan for their own orderly wind down – to write their own will'. He acknowledged that the outcome of this exercise may be the separation of activities, or ever increasingly detailed regulatory oversight at the cost of innovation and efficiency in the financial industry.

Andrew Bailey, BOE's Executive Director for Banking Services & Chief Cashier – 17 November 2009

In a speech at the Santander International Banking Conference in Madrid on 17 November 2009 [17], Andrew Bailey, BOE's Executive Director for Banking Services and Chief Cashier, described the role of the RRP as follows:

- the *recovery* component of the RRP is a bank's 'internal blueprint for recovery in a crisis'. As such it should encompass contingency funding plans and use of contingent capital instruments as well as sale of assets and/or business lines; and
- the *resolution* component of the RRP only comes into play if recovery is no longer feasible, so it should highlight 'where structures need to be changed' in order to facilitate 'an orderly death'.

He cited Northern Rock plc (which was nationalised in February 2008) and Lehman Brothers International (Europe) ('LBIE') (which entered into administration in September 2008) as cases in point to illustrate the importance of having RRPs in place.

A recovery plan would have helped Northern Rock's management understand and address the following key risks:

(i) how its business model could counteract the closure of its key funding markets, given its heavy dependence on securitisation; and
(ii) how it could cope with serious financial stress, given its business model of aggressively pursuing market share by squeezing its net interest margin and accepting more borrower default risk.

In the case of LBIE, two key issues relevant to its resolution were:

(i) what its RRP should have contained by way of resolution options; and
(ii) what changes to its organisation and operations might have made it more straightforward to deal with their collapse.

More specifically, a resolution plan for LBIE (addressing issue (i) above) should have included:

- a detailed balance sheet for all the corporate entities in the group at the most recent month end;
- a clear mapping of financial and operational interdependencies between affiliates;
- wind-down plans for all business areas linked to a comprehensive information data room; and
- a contact plan for major stakeholders.

In turn, LBIE's corporate structure (addressing issue (ii) above) should have been revised as follows:

- corporate entity based accounts and management information supplementing the business-line version;
- clear segregation of client asset handling activities;
- controls over depositing client money with affiliates;
- employees hired by the entity for whom they work;
- a clear record of each entity's title to business and associated intellectual property;
- robust risk systems that allow ready provenance of the balance sheet;
- contracts for the provision of key business services, including banking systems, that allow continuity of provision of services in the event of a resolution; and
- arrangements for continuity of access to payment and settlement systems.

Paul Tucker, BOE's Deputy Governor, Financial Stability – 16 November 2009

On 16 November 2009, Paul Tucker, BOE's Deputy Governor, Financial Stability, announced that 'firms would have to draw up RRPs in the next six to nine months'.[18] Press sources have since reported that the FSA has begun pilot-testing the 'living wills' exercise with certain banks.[19]

G20 and the FSB

The G20 are also seen as generally supportive of the 'living wills' concept, despite objection from some firms which argue that it is almost impossible to draft such a plan in advance without knowing the cause of any future crisis. In the communiqué issued on 7 November 2009 following a meeting of the Finance Ministers and Central Bank Governors in St. Andrews[20], the G20 cited the FSB's pending work to reduce the 'moral hazard' problem and called for the 'rapid development of internationally consistent, firm-specific recovery and resolution plans and tools by end-2010'.

The FSB is reportedly running a list of 30 systemically important cross-border financial institutions, consisting of 24 banks and 6 insurance companies, which they regard as posing a significant risk to the global financial system.[21] These institutions are deemed to warrant special regulatory oversight on a cross-border basis, through newly established colleges of supervisors.

Conclusion

As discussed above, while the UK Parliament continues to deliberate on the Financial Services Bill, including the provisions relating to RRPs, the FSA has been engaged in piloting exercises with some of the larger UK banks for the development of suitable RRPs.

Meanwhile, some global banks are already restructuring themselves to separate their retail (or utility) banking business from their commercial and investment banking arms. For example, Barclays Group announced major restructuring plans on 3 November 2009, which will segregate its retail banking business from its corporate and investment banking business.[22] It is entirely possible that other banks may follow.

We will continue to monitor further developments and provide updates on the details of the RRPs which financial institutions will be required to establish (such as the specific contents required to be included in the plans, the ongoing obligations for their review and revision and the mechanics of compliance), as well as the extent of the related supervisory powers which may be given to the FSA (such as the review, approval, implementation or enforcement of the plans).

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13. House of Commons' Treasury Committee First Special Report of Session 2009-10 (27 November 2009), *www.publications.parliament.uk/pa/cm200910/cmselect/cmtreasy/47/47.pdf*.
14. Speech by Mervyn King , Governor of the Bank of England, at the Lord Mayor's Banquet for Bankers and Merchants of the City of London at the Mansion House (17 June 2009), *www.bankofengland.co.uk/publications/speeches/2009/speech394.pdf*.
15. Speech by Paul Myners CBE, Financial Services Secretary to the HM Treasury, 'Developing a new financial architecture: lessons learned from the crisis',

at the Financial Times Global Finance Forum (18 September 2009), *www.hm-treasury.gov.uk/press_82_09.htm*.

16.Speech by Mervyn King, Governor of the Bank of England, to the Scottish Business Organisations, Edinburgh (20 October 2009), *www.bankofengland.co.uk/publications/speeches/2009/speech406.pdf*.

17.Speech by Andrew Bailey, Executive Director for Banking Services & Chief Cashier of the Bank of England, at the Santander International Banking Conference in Madrid (17 November 2009), *www.bankofengland.co.uk/publications/speeches/2009/speech412.pdf*.

18.Speech by Paul Tucker, Deputy Governor, Financial Stability, Bank of England at SUERF, CEPS and Belgian Financial Forum Conference: Crisis Management at the Cross-Road, Brussels (16 November 2009), *www.bankofengland.co.uk/publications/speeches/2009/speech410.pdf*.

19.See, eg, 'FSA's powers to demand "living wills" may stretch beyond banks' (*Guardian*, 19 November 2009), www.guardian.co.uk/business/2009/nov/19/fsa-living-wills-financial-services-bill; 'Thirty groups on systemic risk list' (*Financial Times*, 30 November 2009), *www.ft.com/cms/s/0/c680e0da-dd4e-11de-ad60-00144feabdc0.html?nclick_check=1*.

20.G20 Communiqué: Meeting of Finance Ministers and Central Bank Governors, United Kingdom (7 November 2009), *www.g20.org/Documents/2009_communique_standrews.pdf*.

21.See, eg, 'Thirty groups on systemic risk list' (*Financial Times*, 30 November 2009), *www.ft.com/cms/s/0/c680e0da-dd4e-11de-ad60-00144feabdc0.html?nclick_check=1*. The article reports that the FSB's list contains six insurance companies ('Axa, Aegon, Allianz, Aviva, Zurich and Swiss Re') and 24 banks ('Goldman Sachs, JPMorgan Chase, Morgan Stanley, Bank of America Merrill Lynch and Citigroup of the US; Royal Bank of Canada; UK groups HSBC, Barclays, Royal Bank of Scotland and Standard Chartered; UBS and Credit Suisse of Switzerland; France's Société Générale and BNP Paribas; Santander and BBVA from Spain; Japan's Mizuho, Sumitomo Mitsui, Nomura, Mitsubishi UFJ; Italy's UniCredit and Banca Intesa; Germany's Deutsche Bank; and Dutch group ING').

22.Barclays Group press release, 'Barclays Broadens Executive Committee' (3 November 2009), *www.newsroom.barclays.com/content/Detail.aspx?ReleaseID=1648&NewsAreaID=2*.

New Financial Regulatory Reform Bill Impacts Corporate Governance

In November 2009, Senator Christopher Dodd (D-Conn) introduced a draft discussion bill titled the 'Restoring American Financial Stability Act of 2009'. The draft bill was a sweeping proposal to overhaul the national financial regulatory regime by, among many other things, creating an independent regulatory body with the responsibility to monitor consumer financial products as well as an independent agency tasked with identifying risks posed to the economy by the complex products and activities of 'too big to fail' financial institutions and other companies. The draft also contained several provisions impacting corporate governance at public companies, including provisions relating to say on pay, majority voting in uncontested elections, and independent compensation committees, among others.

On 15 March 2010, Mr Dodd unveiled the proposed bill in its current form, now appropriately titled the 'Restoring American Financial Stability Act of 2010'. In many ways, the portions of the bill impacting corporate governance are very similar to those in the discussion draft. However, there are a few notable exceptions as well as some portions of the bill that may raise significant questions for boards, compensation committees, and their respective advisors.

Corporate governance provisions

Say on pay

Mr Dodd's bill would require issuers to include in their proxy statements 'a separate resolution subject to shareholder vote to approve the compensation' of their executives. The vote would not be binding and expressly could not be construed as overruling any of the board's decisions, creating any new or different fiduciary duties, or limiting the ability of shareholders to make proposals for inclusion in proxy materials related to executive compensation.

Majority voting

The bill would require directors in uncontested elections to receive a majority of the votes cast to be elected. If a director receives less than a majority of the votes cast, he or she would be forced to tender his or her resignation, whereupon the board would be required to either accept the resignation and determine (and disclose) a date on which the resignation will take effect, or unanimously decline to accept the resignation and disclose the specific reasons for that decision and why that decision was in the best interests of the issuer and its shareholders. With respect to contested elections, the Dodd bill provides that directors would be elected by a plurality.

Shareholder activists may find this effort unsatisfying since it seemingly fails to force public companies to adopt a true majority standard for election of directors in uncontested elections. Others may wonder why this legislation on this subject is necessary since the prevailing investor attitudes and institutional marketplace pressure have already led well over half of the Fortune 500 to adopt some form of majority voting, with the trend ostensibly continuing in that direction.

Proxy access

The Dodd bill provides express authority for the SEC to promulgate rules requiring inclusion of shareholder nominees in the issuer's solicitation materials and outlining the procedures to be followed by the issuer in relation to that solicitation. The bill only authorises, and does not actually require, the SEC to take action in this regard (as opposed to the November 2009 discussion draft, which would have required the SEC, within 180 days of enactment of the proposed legislation, to issue proxy access rules). Some may view this provision as unnecessary since the prevailing view has been that the SEC already possesses the authority to pass proxy access rules. Indeed, the SEC has already proposed proxy access rules and appears to be headed in the direction of adopting rules, perhaps in the near term.

Compensation committee independence

The Dodd bill requires listed companies to have an entirely independent compensation committee. Independence for this purpose would be determined considering certain factors, including the source of the director's compensation (including any consulting, advisory, or other compensatory fee paid by the issuer) and whether the director is affiliated with the issuer or its subsidiaries. The rules promulgated by the SEC pursuant to this provision must allow the exchanges to exempt certain relationships from the independence requirements as the exchanges determine appropriate.

Arguably, this section of the bill is largely unnecessary given the current NYSE and Nasdaq rules that require independent compensation committees, subject to certain phase-in rules and certain exceptions that the exchanges have determined are appropriate (eg, the 'controlled company' exemptions). It seems likely, however, that the desired end result is a stricter independence standard than the current exchange rules (one that looks more like the audit committee independence requirements contained in the Securities Exchange Act of 1934). If that is the case, then one could wonder why the bill leaves the final definition up to the SEC's rules as opposed to specifying it directly in the statute.

Compensation consultants and other advisors

Prior to selecting a compensation consultant, legal counsel, or other advisor, compensation committees would be required to take into consideration certain factors – which the SEC is to identify in rules – that bear on the independence of those advisors. The Dodd bill lists some of those factors, including the provision by the advisor's firm of other services to the issuer; the amount of fees received from the issuer as a percentage of the advisor firm's total revenue; the policies and procedures of the advisor's firm that are designed to prevent conflicts of interest; and with respect to the advisor himself or herself (as opposed to the advisor's firm), any business or personal relationship of the advisor with a member of the compensation committee, and any stock of the issuer owned by the advisor.

In addition, issuers would be required to disclose in their proxy materials whether the compensation committee retained or obtained the advice of a compensation consultant and whether 'the work of the compensation committee has raised any conflict of interest and, if so, the nature of the conflict and how the conflict is being addressed' (this latter requirement presumably relating to conflicts of interest with respect to compensation consultants only).

Note that this does not actually mandate the use of only 'independent' compensation consultants or other advisors or prohibit 'conflicts of interest'. Instead, it simply requires the compensation committee to take certain independence-related factors into account before retaining those advisors. Furthermore, in the absence of clarifying rules by the SEC, it is not entirely clear if the issuer would need to disclose whether the compensation committee reviewed any of those factors or its conclusions in connection with that review. The bill does provide for disclosure of whether the work of the compensation committee raised any conflict of interest, but it is not clear what that means with respect to the independence of advisors. For example, if a compensation consultant performs other services for the issuer, or owns stock of the issuer, or otherwise has circumstances that, based on the independence factors to be outlined by the SEC, would negatively bear on the consultant's independence, would that constitute a conflict of interest that must be disclosed? In addition, the inclusion of 'legal counsel and other advisors' may raise interesting issues for company counsel participating in activities that could be considered rendering advice to compensation committees such as drafting or reviewing portions of the issuer's proxy statement or providing guidance on issues related to executive employment or severance agreements. Will this provision result in compensation committees thinking twice about using long-time company counsel on these matters? In situations where company counsel is not retained directly by the compensation committee but is nevertheless asked by management or the committee to render advice to the committee (such as during the course of a meeting), would the committee be required under that circumstance to evaluate the advisor's independence before acting on its guidance?

Disclosure of pay versus performance

The bill would require the SEC to promulgate rules requiring issuers to disclose in their proxy materials information showing the relationship between executive compensation and the financial performance of the issuer. The bill provides that such information should take into account any change in the value of the issuer's shares and may include a graphic representation of the information required to be disclosed.

If this bill becomes law, it will be interesting to see what rules the SEC proposes regarding disclosure of the relationship between executive compensation and financial performance. The term 'financial performance' can be broadly interpreted, and it is not entirely clear from the text of the bill what is intended in that regard. To further muddy the waters, the 11-page bill summary that the United States Senate Committee on Banking, Housing and Urban Development posted describes this section in a manner very different from the actual text of the bill, saying that it '[d]irects the SEC to clarify disclosures relating to compensation, including *requiring* companies to provide charts that compare their executive compensation with *stock performance* over a *five-year* period' (emphasis added). The text of the bill does not require charts (rather, it allows charts), it does not require a comparison of compensation with stock performance (instead it requires a comparison with financial performance, as discussed above), and there is no mention in the text of the bill of a five-year period (in fact, by tying the discussion to the information required to be disclosed by Item 402 of reg S-K, it appears that the comparison should cover no more than a three-year period).

Clawbacks

A listed company would be required to develop and implement a policy providing:

- for disclosure of its policies regarding any incentive-based compensation that is based on financial information required to be reported under the securities laws; and
- that, if it is required to prepare an accounting restatement due to its material noncompliance with any financial reporting requirement, it will recover from any current or former executive officer who received incentive-based compensation (including stock options awarded as compensation) during the three-year period preceding the restatement, based on the erroneous data, in excess of what would have been paid to the executive officer under the accounting restatement

Section 304 of the Sarbanes-Oxley Act of 2002 (SOX) already contains a clawback provision. However, the standard proposed under the Dodd bill is stricter than the SOX standard because SOX requires that the restatement due to material noncompliance occur 'as a result of misconduct' before it mandates clawing back executive compensation. The Dodd bill dispenses with the 'misconduct' idea altogether.

Employee and director hedging disclosure

Issuers would be required to disclose whether any employees or directors are allowed to purchase financial instruments to hedge a decline in value of equity securities (i) granted to them as part of their compensation, or (ii) otherwise held by them directly or indirectly (presumably the securities intended to be covered by this second clause are only securities of the issuer, although the bill is not written that way). The bill does not require disclosure of whether or not such individuals have actually purchased those hedging instruments or address penalties the issuer may impose on those individuals if they do so. Note that Item 402 of Regulation S-K arguably already requires this disclosure in an issuer's compensation discussion and analysis (CD&A) because it includes 'the registrant's equity or other security ownership requirements or guidelines (specifying applicable amounts and forms of ownership), and any registrant policies regarding hedging the economic risk of such ownership' as an example of what may constitute material information that should be disclosed.

Chairman and CEO structure

Under the Dodd bill, issuers would be required to disclose in their proxy statements the reasons why the issuer has chosen either to combine or separate the positions of chairman of the board and CEO. Item 407 of Regulation S-K already essentially requires this disclosure.

Notable omissions

The current bill contains some notable omissions from the corporate governance provisions proposed in the November 2009 discussion draft. The discussion draft would have required issuers to disclose in their proxy statements any policy relating to 'golden parachute' payments for executives and would have provided shareholders with a non-binding vote on that policy. The current bill contains no such requirements. In addition, the discussion draft provided that public companies would be prohibited from having a board of directors with staggered terms unless adopted or ratified in advance by the shareholders of the company (companies that already had boards with staggered terms not approved by shareholders would have been required to seek shareholder approval at the first annual meeting after the SEC rules are adopted). The recently released version contains no such prohibition.

Conclusion

It is difficult to anticipate the full effect that the Dodd bill would have on corporate governance practices without knowing the content of the various rules that the SEC would issue under it. Nevertheless, a few things are apparent: majority voting in some form and say on pay would likely become required practices in the very near term; the legislative and regulatory emphasis on independence in the board room and on curbing perceived abuses in executive compensation practices would continue unabated; and if there was any question about the SEC's authority on proxy access rules, the Dodd bill would put those questions to rest. The Senate Committee on Banking, Housing, & Urban Affairs approved the Dodd bill in a 13-10 vote on 22 March 2010, and the bill will now make its way to the Senate floor. Senate Majority Leader Harry Reid (D-Nev.) has indicated that he would like to see the Senate vote on the bill before its recess at the end of May.

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Basel 2 and the availability and terms of trade finance Part I

Background

International trade has been severely affected by the current global recession: in 2009 trade volume actually contracted by about 12%, the sharpest fall since the Second World War (Lamy, 2010). The contraction in trade has been associated with a decline in the value and volume trade financing which reflects partly adverse macroeconomic conditions affecting world trade for but also a tightening in the availability and terms of such financing. According to some recent estimates this tightening has made a significant contribution to the contraction of trade, especially during the early part of 2009.[1] Among specific factors contributing to this tightening which are cited in recent global surveys of trade finance are increases in capital requirements due to the introduction of Basel 2.

Two surveys (conducted by the International Chamber of Commerce and by the Bankers' Association for Finance and Trade (BAFT) and the IMF in August 2009 indicate the scale and geographical distribution of the contractions for the major categories of trade finance and point to widespread increases in its price. According to the BAFT-IMF survey (BAFT, 2009a: Appendix 1), which covered 88 banks in 44 countries, there was a small increase of 4% in the value of trade finance between the fourth quarters of 2007 and 2008 followed by a sharp fall of 11% between the fourth quarter of 2008 and the second quarter of 2009. For six emerging-market regions (Emerging Europe, Southeast Europe and Central Asia, developing Asia, Middle East and Maghreb, Emerging Asia and Sub-Sahara Arica) there were contractions in the value of trade finance for all but Middle East and Maghreb during the first period and for all except Emerging Asia (where there was no change) during the second period. There were also declines in both periods for major categories of trade finance, the value of letters of credit contracting 2% in the first period and 8% in the second.

The ICC Banking Commission survey, conducted in the winter of 2009 when the pressures on financial markets during the aftermath of the disappearance of Lehman Brothers were particularly acute and covering 122 banks in 59 countries, found not only that substantial proportions of responding institutions had recently decreased credit related to trade finance but also that there had been increases in the proportion of trade-finance transactions involving lower risk such as those supported by letters of credit and insurance or guarantees and a reduction in the proportion involving the simpler, cheaper but also potentially riskier open-account transactions (ICC Banking Commission, 2009: 20-21 and 34-36).

Substantial proportions of responding institutions (more than 40%) in the ICC Banking Commission survey reported increases in their fees for guarantees and commercial and stand-by letters of credit (ICC Banking Commission, 2009: 36-37). (For explanation of major techniques of trade financing see Box 1.)

Box 1. Techniques of trade financing

Trade financing is an umbrella term covering several different categories of financial transaction including payments or transfers and insurance as well as credit techniques. A clear distinction between payments or transfers and credit in trade financing is difficult to draw: the lags associated with most methods of payment or transfer necessarily entail the exposure of exporters, their agents and financial institutions to importers in international trade during the period before the receipt of the proceeds due from the latter; and the terms of credit related to many trade transactions are linked to the way in which proceeds will be transferred. Many of the techniques of trade financing are designed to shift risks between exporters or importers and financial institutions and between financial institutions themselves, or to accelerate the receipt of proceeds. The letter of credit, one of the best known and most widely used techniques of trade financing, is primarily a device for assuring security of payment, while bankers' acceptances which are often issued on the basis of letters of credit are credit mechanisms. However, both techniques expose a bank to credit risks. Other techniques such as lines of credit from banks to exporters and importers, buyer credits, project financing and international leasing are credit mechanisms. Guarantees and insurance linked to trade transactions are also included in trade finance and expose banks to credit risk but are not credit mechanisms as such.

In the surveys to which reference is made in the text – and in the representations as to the negative influence of Basel 2 – the principal focus is on open account, letters of credit and short-term credit linked to trade.

Open account is a method of settling trade transactions without the use of documentary instruments determining the obligation to pay. Under the procedure the exporter presents to the importer an invoice specifying the terms of sale and payment. To cover the period before collection of the proceeds the exporter may seek short-term credit from its bank with a maturity matching the terms in the invoice.

A *letter of credit* is an instrument issued by a bank at the request of a customer under which the bank promises to pay to a beneficiary a sum of money within a stated period on the receipt of documents and the fulfilment of other terms specified in the letter of credit. Letters of credit have the advantage to an exporter of providing a set of rules which assure payment, and to a bank of separating payment from exposure to debts linked to the underlying sales. The flexibility of the letter of credit as an instrument for assuring payment has the consequence that it can take several different forms – revocable or irrevocable, sight or time, assignable/transferable, revolving, back-to-back, stand-by, etc. – and that it is used in domestic as well as cross-border trade.

Time letters of credit defer payment to a date subsequent to the presentation of documents and the fulfilment of the other conditions but can serve as the basis of financing for the beneficiary under a bankers' acceptance. In a trade-related banker's acceptance the importer applies to a bank for a credit until he has the money to pay the exporter (for example, by selling the imported goods). If the bank is willing to provide its assurance that payment will be made, it notifies the exporter that he may draw a time draft on it. The banks stamps 'accepted' on the draft which then carries the accepting bank's guarantee of payment and becomes a negotiable instrument that can be sold before maturity at a discounted price, thus enabling the exporter to receive payment immediately. Traditionally bankers' acceptances have been used to finance trade in bulk commodities such as cocoa, cotton, coffee and crude oil. However, they are a relatively cumbersome instrument which have become less important in recent years.

Other forms of short-term financing of trade include facilities designed to match the trade cycle of the borrower and through the associated documentation to minimise the risk to the lending bank. The monitoring associated with such facilities enables banks to make informed decisions concerning eventual renewal or prolongation of its exposure to a borrower.

Data on the shares of different techniques of trade finance in international trade are fragmentary. According to a survey of Global Business Intelligence, presumably conducted before the credit crisis, 78% of international trade was carried out through open account and 15% through letters of credit. However, a higher proportion of international trade involving developing countries was carried out through traditional documentary techniques such as letters of credit (ICC banking Commission, 2009: 20). According to the 2009 BAFT/IMF survey the proportion trade carried through open account was 45% at the end of 2007 and had fallen still further to 40 per cent by the second quarter of 2009. The counterpart of this decline was an increase in the use of cash-in-advance financing and bank-intermediated finance (which would include letters of credit) (BAFT; 2009a: 2 and Appendix I).

(The account of techniques of trade financing in this Box makes extensive use of Deak and Celusak, 1984: chapters 3-5, Perry, 1989: chapter 8, and Stigum and Crescenzi, 2007: chapter 3.)

Among banks covered by the BAFT/IMF survey which reported an increase in their capital requirements since the outbreak of the crisis 43% reported that Basel 2 had had a negative impact on their capacity to provide trade finance (BAFT, 2009a: 3).[2] These figures confirm feedback to the ICC Banking Commission which indicated that the weightings for credit risk under the Basel 2 requirements for regulatory capital had adversely affected banks' incentives to lend for trade finance. The impact had been especially severe for lending to SMEs and borrowers in developing countries (ICC Banking Commission, 2009: 40)

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Endnotes

1. A model-based estimate of the contribution of tighter trade finance by the OECD places it at about one-third during the last quarter of 2008 and the first quarter of 2009 (OECD, 2009). The President of the World Bank has spoken of a contribution of 10-15% during the first part of the year [Bankers' Association for Finance and Trade (BAFT, 2009a: 1).

2. The publicly available summaries of the survey do not specify the proportion of banks covered which had increased their capital requirements.

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