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News Bulletin

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"R&R" the Hard Way – the FSA's Consultation on Recovery and Resolution

The UK's Financial Services Authority ("FSA") published its consultation paper on Recovery and Resolution plans on 9 August 2011.[1] "R&R" is perhaps better known as a military term for "rest and recuperation." Whilst the concept of recuperation features strongly in the FSA paper, there seems to be little scope for rest on the part of financial institutions covered by the proposals which will be expected to put detailed plans in place during the next year.

Background

Following the implementation of the Banking Act 2009, which created a special resolution regime for banks and building societies in the UK, the Financial Services Act 2010 required the FSA to establish rules under which UK-incorporated deposit-takers will develop recovery and resolution plans ("RRPs") or "living wills," as they have also been termed. The FSA's consultation paper sets out its proposals for the preparation of such plans. It also provides additional requirements for investment firms to undertake planning in relation to their client money and custody assets ("CMA") holdings. Finally, the consultation paper includes a "Discussion Paper" section in which the FSA canvasses views in relation to certain issues relevant to the resolution of financial services firms.

The obligation to prepare RRPs will apply to all UK-incorporated deposit-takers and to certain investment firms. The FSA states that the scope of the regulation in relation to such firms is still under consideration but its current proposal is that investment firms with assets exceeding GBP15 billion should be subject to the requirement.

RRPs will be required to cover two principal aspects: (i) recovery plans which require firms to identify options to recover their financial strength and viability in the event of the institution coming under severe stress and (ii) resolution planning, requiring firms to submit detailed information about their business in the form of a "resolution pack" to enable the relevant authorities to ensure an orderly resolution can be carried out if necessary when recovery is not possible and the firm has reached the point of non-viability. The FSA acknowledges that it is to be broken up and its functions transferred to the new Prudential Resolution Authority ("PRA") and Financial Conduct Authority ("FCA"). It believes, however that most of the policy and rules for the preparation of RRPs will have been implemented before the PRA takes on the prudential supervisory role of the FSA.

The FSA also notes that the consultation paper is being developed against the backdrop of other relevant initiatives in the UK and the EU, and internationally. These include (i) the EU Commission's consultation papers on crisis management and recovery and resolution planning for credit institutions and potentially some other

[1] CP11/16, "Recovery and Resolution Plans," http://www.fsa.gov.uk/pubs/cp/cp11_16.pdf.

financial institutions within the EU,[2] (ii) the work by the Financial Stability Board ("FSB") and the Basel Committee on Banking Supervision ("BCBS") on globally systemically important financial institutions ("G-SIFIs") including the paper published by the FSB on 19 July 2011 relating to proposals for RRPs for G-SIFIs,[3] and (iii) the UK Independent Commission on Banking (the "ICB"), which published its interim report in April 2011 in respect of relevant issues relating to UK banks and is due to publish its final report on 12 September 2011.[4]

The various initiatives listed above overlap to some extent, although their scope varies. The FSA's consultation paper in relation to RRPs does not apply to the UK branches of non-UK banks. Branches of EU banks will, however, be subject to the EU rules (which will also apply to UK banks) and the FSA states it will discuss the arrangements for resolving such branches with the home regulator through relevant Crisis Management Groups or Cross-Border Stability Groups.

Other jurisdictions internationally have also published plans to require banks to publish RRPs. Notably, in the U.S., the Federal Deposit Insurance Corporation ("FDIC") and the Federal Reserve Board of Governors ("FRB") published a draft rule in March 2011 pursuant to section 165 of the Dodd-Frank Act relating to resolution plans and credit exposure reports to be published. Section 165 requires enhanced supervision and prudential standards for U.S. and foreign nonbank financial companies designated as systemically important under the Dodd-Frank Act and to bank holding companies and foreign-based bank holding companies with total consolidated assets of at least $50 billion.[5] Although the FDIC has indicated it expects the final rule to be published by the end of August 2011, it has not been issued as of now. These provisions are likely to require many banks headquartered outside the U.S., including some European banks, to be subject to the requirement to produce living wills and credit exposure reports in the U.S., giving rise to concerns by banks that might be covered by these rules as to whether the U.S. requirements will be consistent with those they have to prepare in their home jurisdiction. At a meeting on 6 July, Michael Krimminger, the FDIC's General Counsel, stated that the final rule implementing section 165 will be consistent with the requirements of the FSB. It remains to be seen, however, how much international cooperation there will be following the implementation of rules in the UK, EU, the U.S., and other jurisdictions in relation to the preparation of RRPs by large internationally active banks and other financial institutions to seek to ensure they are subject to consistent and non-duplicative requirements.

Recovery Plans

The FSA states that the purpose of a recovery plan is to enable firms to establish a plan for how they could seek to recover from severely adverse conditions that threaten their failure. It notes that stresses could be caused by either idiosyncratic problems specific to the institution or arise from a market problem (or a combination of both). Recovery plans should be capable of being implemented swiftly when required and should be integrated within the firm's risk management framework and processes. The FSA will require each firm's plans to set out a menu of credible options that can be selected depending upon relevant circumstances at the time; firms are therefore not expected to rank the options or set out a pre-determined programme of recovery actions.

Firms will be required to submit their recovery plans to the FSA as part of the supervisory process and the plans should be integrated into their existing governance framework, be regularly reviewed and updated, and be subject

[2] See our client alert, "European Resolution and Recovery Framework for Financial Institutions," http://www.mofo.com/files/Uploads/Images/110217-European-Resolution-Recovery-Framework.pdf.
[3] FSB Consultative Document, "Effective Resolution of Systemically Important Financial Institutions – Recommendations and Timelines," http://www.financialstabilityboard.org/publications/r_110719.pdf. See also our client alert on the FSB Consultative Document, "SIFI Resolutions and Living Wills: The Financial Stability Board Proposal (and some U.S. and UK observations)," http://www.mofo.com/files/Uploads/Images/110819-SIFI-Resolutions-Living-Wills.pdf.
[4] See our client alert, "ICB Interim Report on UK Banking Reform," http://www.mofo.com/files/Uploads/Images/110429-ICB-Report-UK-Banking-Reform.pdf.
[5] See our client alerts "Dodd-Frank Act Rulemaking Update: Proposal for Living Wills and Credit Exposure Reports," http://www.mofo.com/files/Uploads/Images/110331-Dodd-Frank.pdf and "Dodd-Frank Rulemaking Update," http://www.mofo.com/files/Uploads/Images/110711-Dodd-Frank-Rulemaking-Update.pdf.

to oversight and approval by the firm's board or other senior governance committee. The FSA sets out a non-exclusive list of options that it believes should generally be contained in a firm's recovery plans, including:

- Options for restoring capital, liquidity, and profitability, taking into account the effects on profitability of the relevant entity and seeking to ensure that recovery options do not solve short-term capital or liquidity shortfalls at the expense of a firm's long-term financial viability.
- Disposals of businesses or entities, including the possible sale of the entire firm to a third party. This could include disposing of all or part of the firm's business in times of extreme stress. In considering disposal options, the FSA states that consideration should be given to the long-term viability of the firm after the disposal.
- Use of central bank facilities. The FSA states that it expects liquidity planning to include an analysis of how the institution would apply for the use of central bank facilities where available and will expect firms signed up to Bank of England's Discount Window Facility to include a plan for applying its use.
- Raising equity capital in excess of that already anticipated in the firm's business plan.
- A stop on the payment of dividends and bonuses.
- Debt exchanges and other liability management.

The consultation paper states that the options proposed under a recovery plan should be based on certain minimum criteria, including that the benefits should be capable of being realised within an acceptable time period (that the FSA generally expects to be no longer than 6 months). Firms should be able to show the benefits arising from the various options are likely to be material, provide a diverse choice of different options, and be credible to key stakeholders including depositors, creditors, shareholders, and regulatory authorities. The plan should also set out a clear communication strategy as to how the firm would seek to manage any negative market sentiment or a lack of public confidence in the firm.

Firms will be required to develop their own triggers for implementing one or more options under the recovery plan. The FSA states that these should be set early enough to give the measures time to have effect. It also believes a robust trigger framework should contain a combination of qualitative and quantitative indicators and should be capable of being effective in a range of different scenarios, including issues that affect the firm specifically as well as those that impact the market more generally. The FSA gives a non-exclusive list of possible warning signals it believes are likely to be appropriate to activate options under the recovery plan, including the firm's contingency funding plan being triggered, material widening of a firm's CDS spread relative to its peers, and the expectation of a fall in the firm's credit rating.

Resolution Plans

Resolution plans will be prepared by the relevant authorities (likely to be principally the PRA in consultation with the Bank of England and HM Treasury) with the aim of providing a strategy and a detailed roadmap to resolve a failed firm or group in a manner that minimises the impact on financial stability and avoids the need for support from public funds. To enable the authorities to draw up the resolution plan, firms will be required to provide a "resolution pack" containing a significant amount of information and "separability" or "wind-down" analysis in relation to each of its critical economic functions. The resolution pack submission will contain modules covering the following areas:

- Details of significant entities in the group and key structural and operational issues relevant to the separation of significant legal entities. This should include an explanation as to how capital and funding is allocated and managed across the firm and financial dependencies within the group (including lending, derivatives, and securities financing exposures). The FSA states it will take a proportional approach so that the level of information expected from each firm will depend on the firm's size.

- Key metrics on economic functions to illustrate their relative importance. This should cover products or activities of the firm whose withdrawal or disorderly wind-down could have a material impact on the UK economy or financial system.
- A "Critical Function Contingency Analysis" ("CFCA") covering separation and/or "controlled wind-down" for each critical function of the firm. It is envisaged that firms will agree with the authorities which functions are critical and therefore require a CFCA. The CFCA will analyse how each critical economic function can be separated, while either preserving continuity of the function or winding it down in an orderly fashion.
- Plans to overcome any barriers to resolution that the UK authorities consider unacceptable. Such barriers could include (i) economic functions other than deposit-taking being in entities other than the deposit-takers, (ii) whether critical economic functions are provided through a branch or subsidiary, and (iii) co-mingling of economic functions within a single entity.

The FSA states that the guiding principle for resolution planning is the maintenance of financial stability. In particular it states that the authorities are concerned about the continuation of those economic functions deemed critical to the economy and financial system whilst at the same time avoiding the use of public funds to protect shareholders and uninsured creditors. The authorities will also seek to ensure where possible that a failing firm is resolved in such a way so that shareholders and uninsured creditors bear losses in the manner they would in an insolvency of the bank.

Firms will be required to provide the authorities with a viable plan as to how to separate and disconnect each relevant critical economic function from the rest of the business, whatever legal entity structure the firm has adopted. The FSA states that the authorities will also seek to ensure the continuity or the orderly wind-down of crucially important functions at the lowest possible cost consistent with ensuring financial stability. This may require the transfer of some critical functions to one or more private sector purchasers or a bridge bank under the special resolution regime established by the Banking Act 2009. In view of the fact that the authorities may need to resolve a firm over a very short period of time, such as a weekend, the consultation paper indicates that any barriers to resolution should be identified in preparing the RRP and, to the extent possible, eliminated.

Procedures in Relation to RRPs

The FSA states that, as a minimum, a firm's recovery plan should receive approval on an annual basis from the firm's board of directors or equivalent body and each firm should nominate an executive director who will have overall responsibility for the RRP. The FSA states that in preparing the initial RRPs, firms should also plan for their regular maintenance and update. It believes firms should review their recovery plans at least annually and also in circumstances where it undertakes a major reorganisation, especially a major acquisition or disposal. The FSA also intends to implement a process to ensure that RRPs are updated regularly and continue to be fit for purpose.

In relation to the EU consultation papers on recovery and resolution plans referred to above, the FSA states that where it is the home regulator of a firm, recovery plans will need to take account of the overseas subsidiaries of UK deposit-takers as part of the group's business, even though they are regulated by another EU regulator. For UK-headquartered groups, firms will be expected to submit a group-wide recovery plan. In relation to resolution plans, the FSA notes that the EU Commission has proposed that group-level resolution authorities should be responsible for drawing-up and maintaining group resolution plans in cooperation with the other relevant resolution authorities. The FSA states, however, that it believes that each national resolution authority should be ultimately responsible for the legal entities incorporated in its jurisdiction although it accepts that home and host resolution authorities should, before any cross-border bank is placed into resolution, cooperate to seek a coordinated resolution of the parent bank and its cross-border entities in the EU. The FSA notes the EU proposals are still under consultation and EU legislation is expected to be adopted later in 2011. It states that it will review its approach once the EU proposals are finalised and after the FSB publishes its final views on the essential elements of RRPs for global systemically important financial institutions.

Investment Firms

As mentioned above, the consultation paper contains a section specifically in relation to firms undertaking investment business in relation to impact of such firms' failure on CMA. The proposals are intended to supplement the new Special Administration Regime in the UK which modifies UK insolvency law to seek to promote a quicker return of CMA upon the insolvency of an investment firm. The primary source of the FSA's rules in relation to CMA is the CASS sourcebook. The FSA refers to the resolution policy in relation to CMA as the "CASS RP." The FSA notes the scope of the CASS RP will include some firms that are also subject to the RRP but also some that are not. Where firms are subject to both sets of requirements, the FSA states that the CASS RP is intended to apply alongside a firm's RRP as part of the FSA's wider recovery and resolution policy framework.

The FSA states that the principal aim of the CASS RP policy should be to seek to promote a swift return of CMA to clients upon a firm's failure. This will necessitate ensuring that there is sufficient information available to an insolvency officer to access relevant records and information to identify CMA held by the firm. The FSA notes that the insolvency of Lehman Brothers gave rise to particular difficulties and challenges in returning CMA to clients. Schedule 4 to the consultation paper sets out details of the documents, records, and information that firms will be required to maintain in a way that they can be retrieved within 48 hours, including upon a failure of the firm.

Discussion of Issues Relevant to the Resolution of Financial Services Firms

As mentioned above, the consultation paper also includes a "Discussion Paper" section in relation to which the FSA seeks to receive views into certain matters relevant to the resolution of financial services firms. Issues considered are:

Improving Resolvability. Having regard to the recent FSB paper in relation to resolvability in the context of systemically important institutions, the FSA believes that resolution policy should aim to work towards achieving the resolution of institutions promptly, without recourse to public sector support and avoiding disruption and cost to the public and the economy that could occur from widespread interruption to deposit and/or securities accounts, ensuring continuity in consumer-related activities. It is also believes that authorities should have the assurance that shareholders and unsecured creditors (other than insured depositors) are genuinely exposed to loss and bear such losses in the order that would apply in a standard insolvency. In particular, the FSA believes it is important in maintaining market discipline that, as in a normal insolvency, investors and uninsured, unsecured creditors of a failed bank remain exposed to the threat of loss.

The FSA states that a key factor in assessing the resolvability of a firm will be the ability of the authorities to take necessary actions over a short time frame; it refers to this period as a "resolution weekend" (during this time, ideally when markets are closed, the authorities need to ensure that critical banking services can continue without interruption). In developing a firm's resolution plan, the FSA states that there are number of steps they would expect to go through in an approach to enhancing resolvability. The first step will be to assess, based on a firm's RRP, whether it is resolvable or to consider the steps that would need to be taken to make it resolvable. In the UK, this could involve the FSA consulting the Bank of England, the Financial Services Compensation Scheme, and UK Treasury. Having considered whether the RRP has identified the actions that should be taken by the firm or the UK authorities or both to make the firm resolvable, the FSA will enter into a dialogue with the firm which, among other things, should identify its critical economic functions, any further information needed from the firm, and any actions that the firm should be taking immediately to improve its resolvability.

Barriers to Resolution. The FSA notes that the legal structure of banking groups and factors such as where critical functions are positioned within the group, the nature of the holding company, and whether the group uses a branch or subsidiary structure, can pose barriers to resolution. The FSA also states that ensuring the continued provision of and access to services such as IT, data provisions, utilities, and purchasing is important where economic functions of a group are separated during a resolution. The swift identification of services utilised by a critical function and the entities providing those services is therefore regarded as crucial to ensuring continuity in the provision of key services in a resolution. It is also noted that deposit-taking groups will have a number of financial dependencies which can provide challenges to achieving a transfer, sale, or wind-down of a critical economic function. The FSA also specifies that the failure of a deposit-taker, particularly one which is a significant provider of liquidity to the payment systems, could lead to significant disruption to payment systems and lead to a large number of second-tier banks being unable to make or receive payments. It also notes that similar issues arise in relation to clearing and settlement, where a failure can prevent a bank from clearing and settling transactions.

The FSA also observes that there are two approaches to international insolvency: the unitary approach (where a bank is resolved as a single entity and all its assets, wherever located, are pooled together for the benefit of all creditors, wherever located), which is common in the EU and the territorial approach (where each jurisdiction resolves the branch within its territory as if it were a separate independent legal entity), which is more common in the US. The FSA states that although the different approaches do not represent a barrier to resolution as such, they will need to be borne in mind when planning a strategy for resolution.

Trading Book. The FSA states that the potential for serious threats to financial stability arises in particular from a firm which has a sizeable trading book, including where it has significant positions in OTC derivatives and securities lending subject to complex netting arrangements. It believes a conventional insolvency of such an entity is likely to cause significant indirect losses to other market participants and points to the failure of the Lehmans group as demonstrating the risks of relying on a conventional insolvency for resolving a firm with a large trading book. It states that the sale of the trading book or a controlled wind-down could provide alternative means of aiding a swift resolution of such a firm although these approaches also give rise to challenges, particularly as most large firms will have trading books that span more than one jurisdiction. In practice, the FSA believes the authorities will need a variety of these approaches depending on the circumstances of the firm.

Bail-in. The FSA states that bail-in usually refers to a process of internal recapitalisation triggered once a firm has reached the point of non-viability. Losses will be imposed on the holders of certain creditors of the firm by either writing down their claims or by converting them to equity. A key objective to bail-in is that the firm can be resolved so all or part of the firm can continue on a going-concern basis. The FSA notes that the EU consultation papers on crisis management, the interim report of the UK Independent Commission on Banking, and the recent FSB paper on recovery and resolution of systemically important financial institutions are considering this issue.

The FSA distinguishes between (i) a contractual approach between the parties that provides for write-down upon the occurrence of a pre-specified non-viability trigger event (in many cases this will be set at a high level and will be activated before an entity reaches the point of non-viability; the FSA does not consider such arrangement with a high trigger point to be a true bail-in) and (ii) a statutory approach whereby the relevant resolution authority can select from a range of debt instruments (including subordinated and senior unsecured debt) in imposing a write-down or conversion into equity of the instrument at or close to the point of non-viability of the issuer of such instruments. The FSA states that such selection should be consistent with the creditor hierarchy and any bail-in arrangement should be designed with the objective of preserving as far as possible the normal priority rankings in insolvency. The FSA states that whilst the statutory approach gives the authorities more flexibility, the approaches are not mutually exclusive and may be able to be complementary.

Next Steps

Responses to the consultation paper should be received by 9 November 2011. The FSA is then expected to publish a policy statement in the first quarter of 2012. It states that it expects certain provisions to come into effect during the first quarter of 2012 and that firms will have until June 2012 to prepare their initial RRPs.

Contacts

Peter J. Green
+44 20 7920 4013
pgreen@mofo.com

Jeremy C. Jennings-Mares
+44 20 7920 4072
jjenningsmares@mofo.com