Consultation Paper

CP11/16***

Financial Services Authority

Recovery and Resolution Plans

Financial Services Authority

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Contents

The Financial Services Authority invites comments on this Consultation Paper. Comments should reach us by 9 November 2011.

Comments may be sent by electronic submission using the form on the FSA's website at: www.fsa.gov.uk/Pages/Library/Policy/CP/2011/cp11_16_response.shtml.

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Acronyms used in this paper

AFME	Association for Financial Markets in Europe
authorities, the UK	Together, the FSA (and successor organisations), HM Treasury, and the Bank of England
BACS	Bankers Automated Clearing Services
BAP	Bank Administration Procedure
BIP	Bank Insolvency Procedure
CASS	Client Assets Sourcebook
CASS RP	Client money and assets Resolution Pack
CBA	Cost benefit analysis
CBRG	Cross Border Bank Resolution Group
CCP	Central Clearing Counterparty
CFCA	Critical Function Contingency Analysis
CFP	Contingency Funding Plans *See BIPRU 12.4.10 R*
CHAPS	Clearing House Automated Payment System
CLS	Continuous Linked Settlement
CMA	Client Money and Assets
CMGs	Crisis Management Groups *The international meetings of regulators of banks established under the guidance of the Financial Stability Board in line with its principles for cross-border cooperation on crisis management*
CoCos	Contingent Convertible Capital

CP	Consultation Paper
CPB	Capital Planning Buffer *See BIPRU 2.2*
CPSS-IOSCO	Committee on Payment and Settlement Systems – International Organisation of Securities Commissions
CREST	UK electronic settlement system for equities
DWF	Discount Window Facility
DP	Discussion Paper
EEA	European Economic Area
EWS	Early Warning Signals
EUI	Euroclear UK and Ireland
FCA	Financial Conduct Authority
FS Act 2010	Financial Services Act 2010
FSB	Financial Stability Board
FSMA	Financial Services and Markets Act 2000
G-SIFIs	Global Systemically Important Financial Institutions
ICB	Independent Commission on Banking
IFRS	International Financial Reporting Standards
ILG	Individual Liquidity Guidelines
ILTR	Indexed Long Term Repo
IP	Insolvency Practitioner
ISDA	International Swaps and Derivatives Association
ITM/OTM	In the Money/Out of the Money
KYC	Know Your Client
LBIE	Lehman Brothers International (Europe)
MiFID	Markets in Financial Instruments Directive
OTC	Over the Counter
PIF	Proactive Intervention Framework
PRA	Prudential Regulation Authority

PS	Policy Statement
PSP	Private Sector Purchaser
PVP	Payment versus Payment
RRPs	Recovery and Resolution Plans
RWA	Risk-Weighted Assets
SA	Service Agreement
SAR	Special Administration Regime
SIF	Significant Influence Function
SIFIs	Systemically Important Financial Institutions
SLA	Service Level Agreement
SME	Small and Medium Sized Enterprises
SRR	Special Resolution Regime *The regime introduced by Part 1 of the Banking Act 2009*
SUP	Supervision sourcebook
TPO	Temporary Public Ownership

1 Overview

Introduction

1.1 The recent financial crisis highlighted the need for authorities to have more effective tools and information to enable the orderly resolution of financial institutions without needing to resort to taxpayer support. It also showed there was a need for such institutions to be better prepared to recover from situations of severe stress. This Consultation Paper (CP) covers the proposed requirement for certain financial services firms to prepare and maintain Recovery and Resolution Plans (RRPs) and separately, for some of these firms, and others, to make additional preparations in relation to their investment client money and custody assets (CMA) holdings.

1.2 There are two aspects to RRPs. Recovery Plans require firms to identify options to recover financial strength and viability should a firm come under severe stress. Resolution planning requires firms to submit detailed information about their business and operational structure in the form of a Resolution Pack.[1]

1.3 RRPs aim to ensure that financial institutions:

- assess and document the recovery options which would be available to them in a range of severe stress situations;
- enable these recovery options to be mobilised quickly and effectively; and
- supply the regulatory authorities with information and analysis on their businesses, organisation and structures to enable the authorities to ensure that an orderly resolution could be carried out by the authorities should it become necessary.

1.4 This paper has been prepared by the FSA with assistance from the Bank of England and the Treasury, which together comprise the UK authorities. The FSA is obliged to make rules for RRPs[2] while resolution planning is the responsibility of the Bank of England.

1 The Banking Act 2009 created a Special Resolution Regime (SRR), which has given the authorities a range of tools for resolving failed deposit-taking financial institutions.

2 The Financial Services Act 2010 (FS Act 2010) obliges the FSA to make RRP rules for UK incorporated deposit-takers and to have regard to international standards relating to RRPs.

1.5 Legislation is planned to be enacted under which the FSA will be reformed into the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA).[3] We expect much of the policy and rules for the preparation of RRPs will have been implemented by the FSA before the PRA takes on responsibility for supervising the relevant firms, and have sought to ensure that policy proposals set out in this paper will be compatible with the PRA's objective and the approach it will take to that objective.[4]

1.6 Following the Turner Review Conference in 2009 the UK authorities started a pilot RRP project initially involving four and ultimately involving six of the largest UK firms. The FSA, the Bank of England and HM Treasury are extremely grateful to the pilot firms for the very considerable time and resources that they have dedicated to this project. Their help has been invaluable in developing policy on RRPs.

Structure of this paper

1.7 This paper contains our formal consultation on rules for RRPs and for our CMA proposals (the 'CASS Resolution Pack' (CASS RP)), together with a section which invites discussion of certain matters relevant to the resolution of financial services firms.

1.8 There are a number of documents which have been published alongside this paper: the proposed Handbook text for RRPs and the CASS RP, a guidance pack on how firms should complete their RRPs, and several other annexes including our cost benefit analysis and compatibility statement.

Who should read this paper?

1.9 This CP should be read by all FSA-authorised banks and building societies and significant investment firms. It should also be read by firms subject to the FSA's client asset custody rules and investment business client money rules.

1.10 The papers are likely to be of interest to policymakers and practitioners involved in the resolution of failed firms, and a wider range of authorised firms such as insurers since it is possible that the scope of the requirements for RRPs will be extended to other types of financial services firms in the future (after consultation).

Recovery Plans

1.11 A Recovery Plan must be developed and maintained by the firm and should have the following features:

- a sufficient number of credible options to cope with a range of scenarios, including both idiosyncratic and market-wide stress;

3 This is likely to take effect from early 2013 when the FSA's responsibilities will be split between the PRA and the FCA.

4 The joint paper issued by the Bank of England and the FSA, *The Bank of England, Prudential Regulation Authority: Our approach to banking supervision*, which was published on 19 May 2011, provides further detail on its objective and intended approach to deposit-takers and PRA-regulated investment firms.

- options that address capital shortfalls and liquidity pressures and which should aim to return the firm to a stable and sustainable position; and
- appropriate governance processes, including intervention conditions and procedures, to ensure timely implementation of recovery options in a range of stress situations.

1.12 There may be cases where the firm does not currently have credible options to enable it to recover from extreme stress. In such cases the Recovery Plan should indicate the preparation measures (and a timetable for such measures) that the firm will take to create such options.

1.13 In the case of globally significant financial institutions (G-SIFIs), the Recovery Plan will also assist discussions among international regulators in the Crisis Management Groups (CMGs), established under the guidance of the Financial Stability Board (FSB) and led by the home authority. Recovery Plans will help to reassure host regulators that the firm could deal effectively with difficult circumstances. This cooperation should help to discourage host and home regulators from taking pre-emptive actions to protect national interests which could be to the detriment of wider global interests.

Resolution planning

1.14 The information and analysis in the Resolution Pack provided to the authorities will help the authorities to prepare a resolution plan with the following aims:

- to ensure that resolution can be carried out without public financial support;
- to seek to minimise the impact on financial stability;
- to seek to minimise the effect on depositors and consumers;
- to allow decisions and actions to be taken and executed in a short space of time (for example, over a 'resolution weekend');
- to identify those economic functions for which continuity is critical to the economy or financial system;
- to identify those economic functions which would need to be wound up in an orderly fashion;
- to identify and consider ways of removing barriers which may prevent critical functions being resolved successfully;
- to allow a resolution that separates the identified critical economic functions from non-critical activities which could be allowed to fail; and
- to enhance international cooperation and crisis management planning between international regulators for G-SIFIs.

1.15 Ultimately resolution information and analysis will allow the authorities to commit more credibly to putting firms that fail to meet threshold conditions into resolution in an orderly manner with minimal impact on the financial system, regardless of the size or complexity of the firm.

Scope

1.16 We are required, as a minimum, to make RRP provisions that apply to UK incorporated deposit-takers covered by the FS Act 2010.[5] Our approach is to set out high-level rules and guidance in the Handbook as a new chapter of the FINMAR sourcebook; the detail on how firms should complete their RRPs is in the guidance pack.

Q1: Does the detailed guide to the preparation of RRPs, set out in the RRP guide, give adequate instruction and assistance to prepare an RRP? Are there areas which require further explanation?

1.17 However, we believe that investment firms that could present significant risks either to the stability of the financial system or to one or more PRA-regulated entities within their group should be subject to the same RRP requirements as deposit-takers, including to support their orderly resolution under investment bank Special Administration Regime. We expect such firms will be designated as being subject to regulation by the PRA, but the exact scope of PRA regulation is still being determined.[6]

1.18 In the interim we are consulting on the basis that the FSA's RRP requirements will apply to significant investment firms, in particular, to full scope BIPRU 730k investment firms with assets exceeding at least £15 billion on its last accounting reference date. To the extent that the PRA designation process results in a different population of investment firms being identified, the set of firms caught by RRP requirements will need to be modified (with further consultation as appropriate).

1.19 The proposals relating to CMA (CASS RP) apply to all firms subject to CASS 6 or 7 due to their holding of investment business client money or custody assets. See Chapter 6 for more detail.

International scope of rules

1.20 Given the financial and operational interdependencies often found in a financial services group we expect firms to consider, when providing resolution analysis to the authorities,

5 This is the definition of 'deposit-taker' covered by the Banking Act 2009, which excludes credit unions and some insurers who have permission to accept deposits.

6 As set out in the joint paper issued by the Bank of England and the FSA, *The Bank of England, Prudential Regulation Authority: Our approach to banking supervision*, the PRA will be responsible for the supervision of investment firms that are identified as presenting such risks.

how all significant members of the group (both regulated and unregulated) could be resolved. Recovery Plans should similarly address all significant parts of a group.

1.21 We are not requiring RRPs from UK branches of overseas entities. This is partly because the resolution tools in the Banking Act 2009 are not available to resolve such branches. The arrangements for resolving these branches will need to be pursued bilaterally with the home regulator and through relevant CMGs or Cross Border Stability Groups. We would expect to be given access to home state Resolution Plans for UK branches which we regard as having critically important functions to the UK.

Future developments and implementation

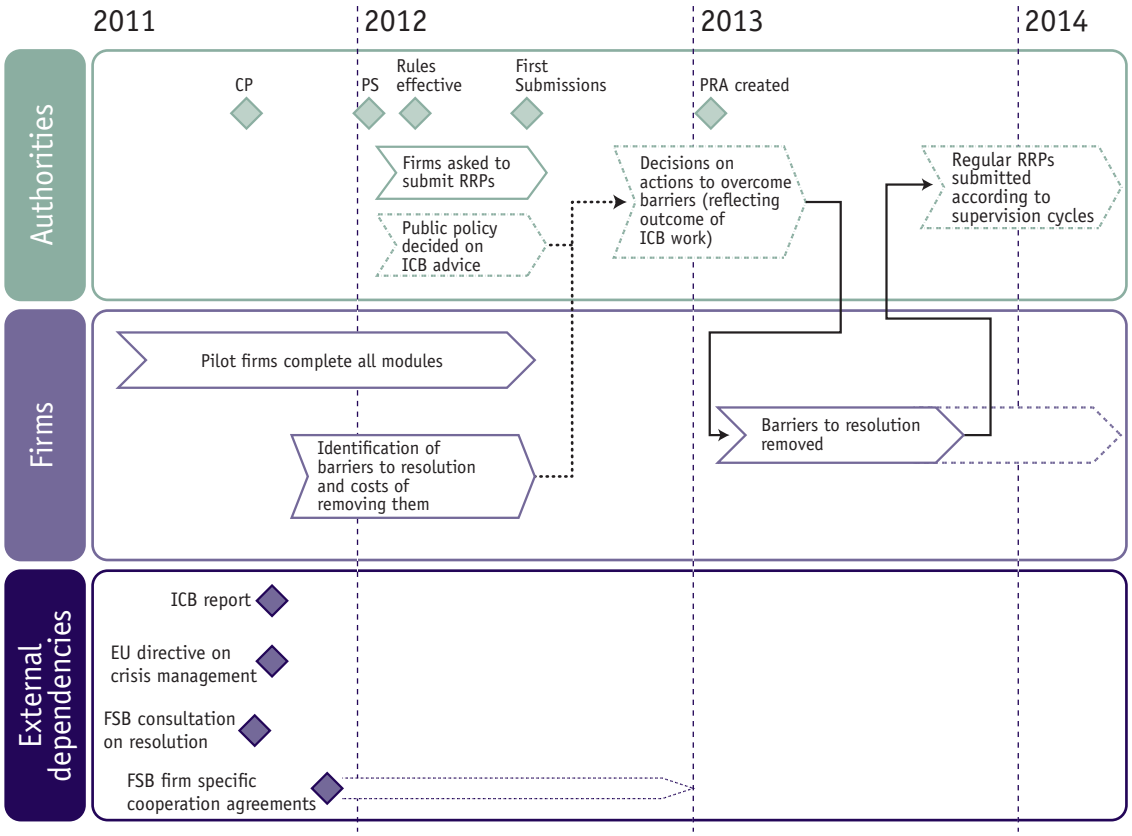
1.22 Following this consultation, we propose to publish final rules in the first quarter of 2012 in a Policy Statement (PS). We expect certain provisions to come into effect during the first quarter of 2012 but to provide transitional provisions so that firms will have until June 2012 to prepare their initial RRPs.

1.23 Our approach to implementation will be iterative and proportional. It will be iterative in that we expect to establish a firm's critical economic functions before asking for more information on those functions, including where necessary plans to alter firms' business operations or structure to address inadequacies in the Resolution Packs.

1.24 Our approach is proportional because the costs to firms will increase with the complexity of the firm. We expect small firms or groups or those with less complex business models to provide less information and to only complete those sections of the RRP guide which are relevant to their operations. See also our Cost Benefit Analysis at Annex 1, which also sets out the estimated compliance costs.

1.25 The provision of the resolution information in RRPs may not be sufficient in itself to establish resolvability without further actions. We are required by the FS Act 2010[7] to consider whether each Recovery and Resolution Plan makes satisfactory provision in relation to the matters required under that Act and, if not, to take such steps as we consider appropriate. This introduces some dependencies on other domestic and international policy developments before we can complete the introduction of an appropriate recovery and resolution regime, which we illustrate in Diagram 1 below:

Diagram 1: Implementation and future developments



1.26 There are three developments expected which will help inform our policy on what is an acceptable cost and level of disruption arising from a firm's failure:

- the EU Commission proposals on crisis management, including preventative powers;
- the results of the FSB's consultation on Effective Resolution of Systemically Important Financial Institutions which includes a package of proposed policy measures to improve the capacity of the authorities to resolve SIFIs[8]; and
- the Independent Commission on Banking (ICB) established in June 2010 by the Chancellor of the Exchequer, chaired by Sir John Vickers, is expected to issue a final report in September 2011.

1.27 In terms of countervailing benefits, the benefits to taxpayers and to the financial sector and the wider economy of increased financial stability are likely to be considerable. The financial stability benefits have been set out in other FSA and external papers (see Annex 1 for further background).

8 See FSB Consultative Document published on 19 July 2011: *Effective Resolution of Systemically Important Financial Institutions* (www.financialstabilityboard.org/publications/r_110719.pdf)

1.28 However, to a large extent, the benefits of the proposals in the CP are conditional on the further development of the proposals in the DP on resolvability. Furthermore, in aggregate, the benefits being assessed must be weighed against not only the costs of improving resolvability (the impact on the financial sector and the economy if a firm fails), but also the costs of making that failure more remote, both through a reduction in moral hazard resulting from a credible no-bail out policy and by raising prudential standards for capital and liquidity.

Consultation Paper

2

Links into existing policy and embedding into supervisory process

SUMMARY

- RRPs complement existing policies with respect to capital, liquidity and stress testing. They are also consistent with the proposed PRA Proactive Intervention Framework (PIF).

Introduction

2.1 As mentioned in Chapter 1, the aim is for the RRP policy set out in this document to come into effect during the first quarter of 2012. In due course, RRP policy as it relates to deposit-takers and systemic investment firms will fall under the remit of the Prudential Regulation Authority (PRA).

2.2 The CASS RP policy will come into effect six months after the publication of the relevant PS. As stated in Chapter 6, firms in scope for the CASS RP will include some firms that are also in scope for the rest of the RRP policy and some that are not.

2.3 As set out in the joint paper issued by the Bank of England and FSA, *The Bank of England, Prudential Regulation Authority: Our approach to banking supervision*, the PRA's role will be to contribute to the promotion of the stability of the UK financial system. It will have a single objective – to promote the safety and soundness of regulated firms, including seeking to minimise any adverse effects of firm failure on the UK financial system and by ensuring that firms carry on their business in a way that avoids adverse effects on the system. As recognised in its statutory objective, it will not be the PRA's role to ensure that no PRA-authorised firm fails.

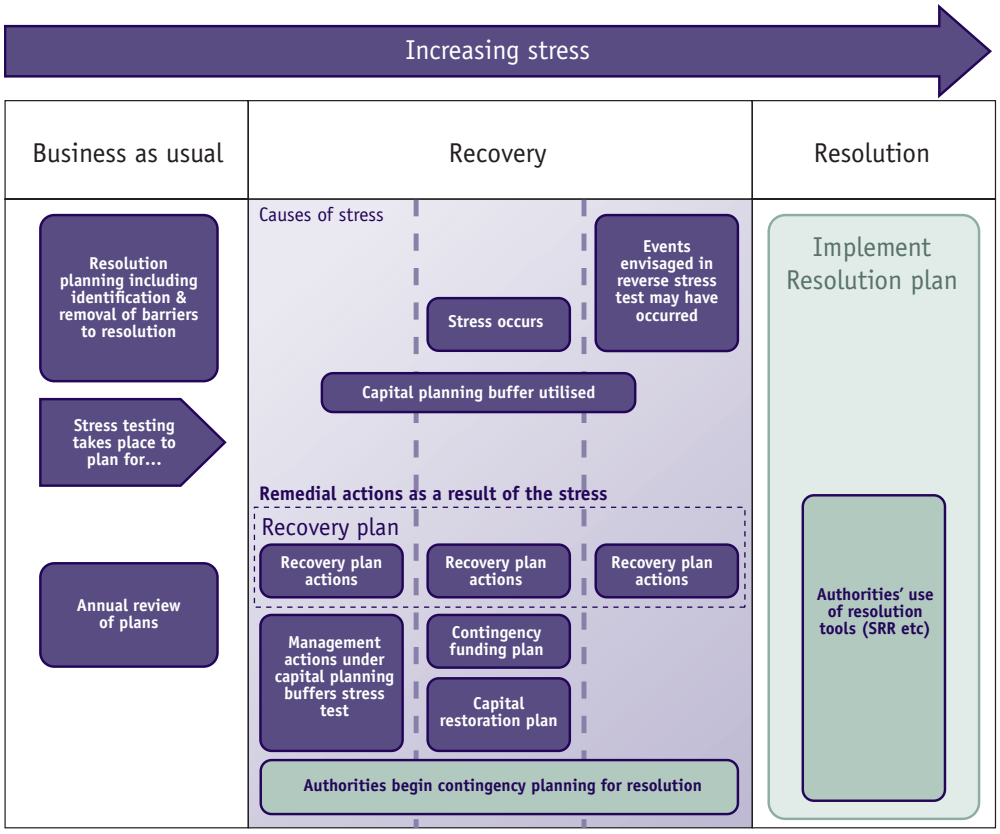
2.4 In the following paragraphs, we explain how the RRP policy set out in this document relates to existing FSA rules and guidance and also how it will be integrated into future supervisory processes within the FSA. These processes are evolving to anticipate the expected supervisory procedures that will be developed in the PRA and FCA.

Links with existing prudential policies

2.5 We recognise that firms are already subject to various requirements to identify threats to their viability and to determine appropriate measures for such eventualities. The RRP can be seen as a development of existing prudential requirements already imposed on firms; the recovery element further supports a firm's financial continuity during severe stress while the resolution element ensures that the firm is able to fail in an orderly manner when recovery actions have failed.

2.6 Diagram 2 below illustrates how a number of these elements fit together.

Diagram 2: RRP link to existing prudential requirements



2.7 The main points to note are that:

- Stress testing requirements are mainly concerned with the identification of the sources of potential losses and the means by which the risk of those losses arising might therefore

be reduced through better controls or management. Where stress testing exercises project capital resources and capital resource requirements, they usually allow for some degree of 'management actions' in response to the stress. Some of these actions may be identified as options in the Recovery Plan.

- Actions identified as part of a firm's contingency funding plan (CFP)[9] or capital restoration plan (CRP) may also be amongst the options included in the firm's Recovery Plan. However, we anticipate that Recovery Plan actions will be relevant both to milder stresses and much more severe stresses. Reproduction of the CRP and CFP therefore will not constitute an adequate Recovery Plan by itself.

- The requirement for firms to identify barriers to resolution as part of the RRP is new and different to our reverse stress testing requirements. Reverse stress testing focuses on minimising the probability of business model failure by reinforcing existing management actions that are already envisaged or commissioning new ones, while RRPs deal with the failure itself.

- The joint paper issued by the Bank of England and FSA, *The Bank of England, Prudential Regulation Authority: Our approach to banking supervision* describes a Proactive Intervention Framework (PIF). This framework will map the PRA's assessment of risk to a firm's viability to one of five stages and at each stage the PRA will ensure that remedial actions of an appropriate size and speed are taken to reduce the probability of failure, as well as actions the authorities will take to prepare for resolution. The PRA will take account of the remedial actions set out in firms' recovery plans and will require firms to draw on those actions as appropriate where firms have not acted proactively.

- As part of the RRP framework, firms will be required to develop their own triggers to help them decide when to implement their Recovery Plan. It should be noted that, while a firm's triggers will be agreed with the PRA, this will be independent from the PRA's own risk assessment criteria of the firm under the PIF. Chapter 3 sets out how the firm's own trigger framework in its Recovery Plan can interact with the PRA's PIF framework.

Links between the RRP and existing capital stress testing

2.8 There are strong links between the Recovery Plan and the existing capital and liquidity stress testing requirements, given their common objective towards maintaining sufficient financial resources for a going-concern firm in a stressed environment.

2.9 Firms may find that their existing capital and liquidity stress testing can serve as useful inputs in developing their Recovery Plans. However, the Recovery Plan will extend further by asking firms to plan for additional actions when the impact or the speed of a crisis turns out to be more severe than the scenarios they had projected in their stress tests.

9 See BIPRU 12.4.10R BIRPU 12.4.15G

2.10 In terms of how the Recovery Plan may link with the current capital planning buffers (CPB) requirements[10], a firm's CPB will serve as its first line of defence when its capital position comes under pressure during adverse circumstances outside the firm's normal and direct control. The current requirements on CPB require the firm to produce a capital restoration plan when the firm has dipped into its CPB. The capital restoration plan should consider all possible and credible options for restoring its CPB including any capital-oriented options in a firm's Recovery Plan.

2.11 The way in which the Recovery Plan fits into the existing liquidity regime is addressed in Chapter 3.

Links between the RRP and reverse stress testing

2.12 The FSA's policy on reverse stress testing[11] requires a firm to explicitly identify and assess the scenarios that are most likely to cause its business model to fail, after considering existing, realistic management actions. Where those tests reveal that business failure will occur within the firm's existing risk appetite or tolerance, the firm will be required to identify and adopt effective arrangements, processes, systems or other measures to try to prevent those risks from crystallising.

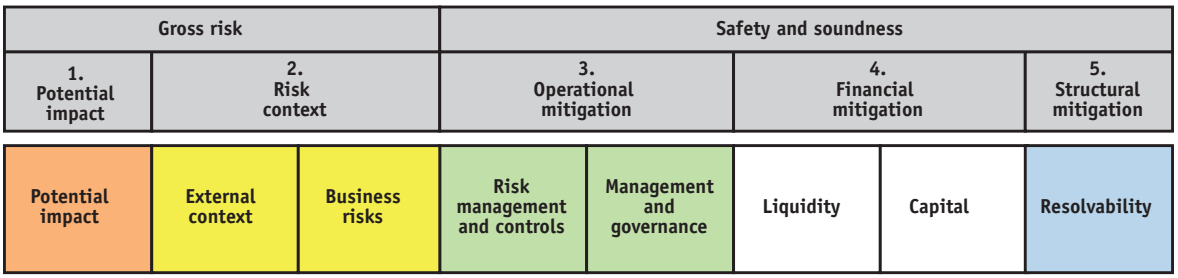
2.13 Given the roles of reverse stress testing in improving a firm's contingency planning as well as in preventing it from failing, there are clear links between reverse stress testing and the RRP requirements. In practice, the development of a firm's RRP will inform its reverse stress testing planning and vice-versa.

Embedding the RRP into the supervisory process

2.14 The PRA's supervisory model is set out in its launch document and we do not repeat it in detail here. The PRA will concentrate its resources and actions on those firms and issues that pose the greatest risks to the stability of the UK financial system. Risks to the stability of the system will be assessed via the five step risk assessment framework shown below. The framework will capture three key elements: (i) potential impact on the financial system of a firm coming under stress or failing; (ii) how the macroeconomic and business risk context in which a firm operates might affect the viability of its business model; and (iii) mitigating factors, including risk management and governance (operational mitigation), a firm's financial strength, including capital and liquidity (financial mitigation), and resolvability (structural mitigation) – which together determine the safety and soundness of a firm – that may reduce the potential risk a firm poses to the stability of the financial system.

10 See BIPRU 2.2
11 See SYSC 20

Diagram 3: PRA's supervisory model



2.15 The adequacy of a firm's recovery options – as set out in its Recovery Plan – will be taken into consideration when assessing financial mitigants, whilst the assessment of resolvability will draw heavily on the information and analysis supplied by the firm, and used by the authorities to develop its Resolution Plan.

2.16 The feasibility of the RRP, the steps necessary to implement improvements to the firm's resolvability and the information needs in resolution may also require specialist skills, including from practitioners with experience of how firms' affairs are dealt with upon failure. We believe that it is desirable for firms to test the feasibility of these aspects of their RRP internally and we expect also to make use of skilled persons' reports to carry out testing in appropriate circumstances.

2.17 Upon the transition from the FSA to the PRA it is anticipated that the PRA will consolidate into a single framework the rules for RRPs, stress testing, capital planning buffers, and contingency funding plans. Provision will also be made to streamline the submission of documents (stress testing information, Individual Capital Adequacy Assessments, and Individual Liquidity Adequacy Assessments, etc.) associated with these rules.

3

Recovery plan

SUMMARY

- Recovery Plans are developed and maintained by the firms and the authorities will review their adequacy.
- Plans should include a robust menu of options to deal with a range of stressed situations.
- Plans should have unambiguous 'triggers' which, when breached, will create a strong presumption that the plan will be activated.
- Plans should be reviewed at least annually and approved by the board.

Introduction

3.1 The purpose of a Recovery Plan is to enable firms to plan how they would try to recover from severely adverse conditions that could cause their failure. It will set out in advance a firm's 'menu of options' for dealing with a range of severe stress events. These stresses may be caused by an idiosyncratic problem, a market-wide problem or a combination of both, and extend beyond the firm's current regulatory stress testing scenarios and remedies.

3.2 Firms will be required to produce a Recovery Plan that can be readily implemented when necessary and that is integrated within its risk management framework and processes. Firms will need to ensure the necessary measures and preparations are in place in advance for the plan to be effective.

3.3 The recovery options need to be material in impact and capable of being executed with relative ease and in a timely manner.

3.4 Our proposals cover the following key areas:

- governance framework for the Recovery Plan;
- key Recovery Plan options;

- criteria for assessing recovery options; and
- intervention conditions, i.e. a trigger framework.

3.5 For a detailed explanation of the expected components of Recovery Plans, see modules 1 and 2 of the RRP Guide. For the handbook rules relating to Recovery Plans, see FINMAR 4.2. Chapter 4 provides an explanation of modules 3 to 6 of the RRP guide covering resolution planning requirements.

Governance framework for the Recovery Plan

3.6 When developing a Recovery Plan, a firm will be required to plan in advance what it could do if it were to suffer a severe stress that could ultimately threaten its survival as a going concern. The Recovery Plan will set out the firm's menu of credible options from which it can select and employ the most appropriate recovery actions, depending on the circumstances. The firm will not be expected to rank these options or to set out a pre-determined programme of recovery actions since these will vary depending on the type and severity of the stress.

3.7 Every firm will be required to submit its Recovery Plan to the FSA on request as part of the normal risk-based cycle of supervision. We also expect to be heavily involved in discussions when implementation becomes necessary and choices of actions are being made.

3.8 Firms must ensure that:

- the Recovery Plan is integrated into the firm's existing governance framework and processes;
- the Recovery Plan is regularly reviewed and updated. Where there are material changes to a firm's business, particularly after an acquisition or disposal, the firm should review and update its Recovery Plan promptly;
- processes are in place for regular monitoring of early warning signs and triggers that prompt implementation of the Recovery Plan;
- processes are in place for timely decision-making and implementation of the plan by the firm's senior management and board of directors when triggers require the plan to be implemented; and
- the Recovery Plan is subject to oversight and approval by the firm's board/senior governance committee.

Key Recovery Plan options

3.9 Under existing prudential requirements, firms are required to plan for the maintenance of adequate capital and liquidity resources under projected stress scenarios. Recovery Plans will require firms to plan for further recovery options in circumstances more severe and

varied than these stress scenarios, where failure of the firm may result if the Recovery Plan does not succeed.

3.10 It is likely, therefore, that the Recovery Plan will feature options that the firm would not consider in less severe circumstances such as:

- disposals of businesses or entities;
- raising equity capital which has not been planned for in the firm's business plan;
- complete elimination of dividends and variable remuneration;
- debt exchanges and other liability management actions; and
- sale of the whole firm to a third party.

3.11 The list above is not meant to be exhaustive but is indicative of the types of options normally available to large firms. Different firms, depending on their size, structure and activities, will have differing ranges of possible recovery actions. The options available to small firms are likely to be fewer and therefore their plans will be simpler, which will align with the PRA's intended approach to proportionate prudential regulation.

3.12 In the following paragraphs, we discuss the options which we expect firms to consider when preparing their Recovery Plans. Firms must ensure that the options do not interfere with the operational stability of the firm and consider the interdependencies between options, including those changing the structure of the firm. For example, firms must ensure that access to financial markets infrastructure and continuity of internal operational processes (IT, availability of staff) are preserved.

Capital, liquidity and profitability

3.13 Firms should consider options for sustaining and restoring their capital and liquidity resources, and profitability during a crisis.

3.14 Recovery Plans should identify the effects on profitability of all options whether they address capital, liquidity or both. The plan should ensure that recovery options do not solve short-term capital or liquidity shortfalls at the expense of a firm's long-term financial viability.

3.15 When considering recovery options to deal with capital difficulties, a firm should consider the possibility that its CPB may be inadequate to absorb losses during a crisis.

3.16 Firms are already required to develop a CFP[12] as part of their normal liquidity management arrangements. While a firm's CFP may form part of its Recovery Plan, the Recovery Plan should also consider liquidity options that are over and above those in its CFP, for surviving a protracted liquidity crisis or a liquidity crisis that turns out to be more severe than the firm has projected in its stress tests, and for which traditional tools may be inadequate.

12 See BIPRU 12.4.10R to BIRPU 12.4.15G

3.17 When developing the liquidity section of the Recovery Plan, it will be important for firms to consider any potential deterioration in liquidity resources that may be caused by other recovery actions (e.g. capital recovery options).

3.18 The availability of liquidity options beyond a firm's CFP may be limited for some firms, particularly smaller firms. However, firms with wider funding access to the private market, may hold back-up liquidity resources that are greater in amount than those required by the FSA or hold assets that do not necessarily meet the regulatory definition of the liquid assets buffer but on which the firm may still rely to meet its liabilities in a liquidity stress.[13]

3.19 A firm's CFP is linked to the stresses contemplated by BIPRU 12.4 requirements and the timeframe needed for certain actions to generate funds may not be within the firm's CFP liquidity risk appetite i.e. their survivability time horizon. Firms should assess therefore, whether these options may still be feasible during a severe or protracted stress, and whether they can be included in their Recovery Plans.

Disposal options

3.20 For the Recovery Plan to be robust, it is likely to be necessary for firms to consider radical choices which change the structure of their businesses. These choices are likely to include, but are not limited to, disposal options for part of a firm's business or even selling the firm itself. Although it may be difficult accurately to assess the value of such options, firms should be able to provide some broad estimates. Consideration of such options and how they might be executed will form an important part of most Recovery Plans, particularly those of the larger firms. When considering potential disposal options, consideration should be given to the long-term viability of the firm post-transaction.

Central bank facilities

3.21 We would expect a liquidity Recovery Plan to include an analysis of how an institution would plan to apply for the use of central bank facilities in stressed conditions (including overseas central bank facilities where available). Alongside bidding in open market operations (including the Bank of England's Indexed Long-Term Repo (ILTR)), we would expect firms signed up for the Bank of England's Discount Window Facility (DWF[14]) to include a plan for applying for its use.

3.22 The DWF provides liquidity insurance to eligible firms[15] to help them address short-term liquidity shocks, providing that the firm meets the Bank of England's eligibility criteria.

13 BIPRU 12.2.18G for example states that a firm can hold liquidity resources that are greater in amount or higher in quality, or maintain a more prudent funding profile than those advised in its ILG based on its own assessment of its liquidity risk profile. Also, a firm may additionally hold assets that, while they do not qualify under the BIPRU 12.7 requirements for inclusion in the regulatory liquid assets buffer, would potentially be available to the firm to assist it to meet its liabilities as they fall due.

14 The ILTR is an auction-based operation where banks can borrow from the Bank of England against a wide range of collateral. The DWF is a bilateral facility that operates by swapping, for a fee, a bank's high quality, but illiquid assets for liquid UK government bonds or, in exceptional circumstances, for cash.

15 See www.bankofengland.co.uk/markets/money/dwf/eligibility.htm for eligibility criteria.

Within a liquidity Recovery Plan, firms signed up for access to the DWF should consider the appropriate amount of assets to 'pre-position' in the DWF to facilitate ease and speed of access to DWF liquidity on an appropriate scale should it be needed. To facilitate this they should include an analysis of what assets they hold that would meet the DWF eligibility criteria[16] and estimate their drawing capacity against those assets, given the haircuts applied to the market value of assets. Firms should also set out in their Recovery Plan the sort of circumstances in which they might request to draw on the DWF and plan to have all the relevant documentation available; we would expect firms to discuss DWF pre-positioning with the FSA/PRA and the Bank of England as a matter of course. Similar considerations should be applied to other Central Bank facilities that could be accessed.

3.23 Firms should only include normally available Central Bank facilities in their plans and should not include anything in the nature of extraordinary liquidity assistance.

Criteria for assessing recovery options

3.24 The options proposed under a Recovery Plan should meet the following minimum criteria:

- The benefits should be capable of being realised within an acceptable timeframe – preferably no longer than six months – and consistent with the objective of recovery.
- The benefits should be material, individually and in aggregate, for them to have an impact and be able to 'move the dial'.
- In combination with the firm's existing crisis management tools, they should collectively be sufficiently diverse so that the firm can make choices, as appropriate, to deal with a range of severe stress events, both market-wide and idiosyncratic.
- They should be credible to key stakeholders e.g. depositors, debt holders, counterparties, shareholders and the authorities.

3.25 The Recovery Plan should also set out a clear communication strategy on how the firm intends to manage potentially negative market sentiment and requirements for disclosures to its stakeholders and the public at large so as to maintain confidence in the firm. This should include adequate and timely transparency of the risk situation of the firm, communication of implemented measures and the ability to communicate the long-term strategic viability of the firm.

Q2: Please give your views on the Recovery Plan proposals for:

- governance;
- key Recovery Plan options; and
- assessment criteria.

16 See www.bankofengland.co.uk/markets/money/dwf/index.htm

Intervention conditions – trigger framework

3.26 A key component of the RRP framework is the determination of when the firm will implement aspects of its Recovery Plan. Firms will be required to develop their own triggers and we encourage firms to set these at appropriate levels in order to reduce the likelihood of intervention by the PRA under the Proactive Intervention Framework (see paragraph 2.7).

3.27 The PIF will help to map the PRA's assessment of risks to a firm's viability to presumed actions to mitigate those risks, as well as to plan for the resolution of the firm. In the context of the RRP, this may include requiring a firm to undertake certain actions in its Recovery Plan. Movement along the stages of the PIF will be based on the PRA's forward-looking supervisory judgement and will therefore not be dependent on a firm's Recovery Plan triggers. Thus, it is hoped that the PIF will create positive incentives for firms to set their Recovery Plan triggers at an appropriate level before supervisory intervention under the PIF.

3.28 Developing triggers that strike an appropriate balance between triggering a plan too early or too late can be challenging. However, having clear triggers is necessary to support timely and decisive action by the firm's senior management.

Characteristics of a robust Recovery Plan trigger framework

3.29 To assist firms in developing their Recovery Plan triggers, we set out below our views on the key elements of a robust Recovery Plan trigger framework:

- the triggers will contain a combination of qualitative and quantitative indicators (see paragraph 3.33 below on quantitative triggers);
- the triggers should be timely;
- the triggers should be effective for a range of stressed situations, including firm-specific, market-wide and a combination of both;
- it should be clear when the triggers have been breached; and
- the triggers should be capable of being easily monitored.

3.30 However, a firm should be prepared to activate its Recovery Plan if it is determined that its viability is at risk, even though none of the triggers have been met.

3.31 The ultimate objective of the Recovery Plan is to enable a firm to avoid failure, so the firm should consider indicators that measure the adequacy of its financial resources and its distance from failure. These triggers need to be set at a level that the firm considers will reflect appropriately the severity of its financial situation.

3.32 The triggers will need to be early enough to give the firm time for the Recovery Plan to have an effect. The triggers should prevent inadequate delays and make sure measures are taken in a phase in which recovery is still likely to succeed.

3.33 The quantitative triggers should contain forward-looking elements to ensure that there is no time-lag before the triggers indicate severe stress in a firm (e.g. a firm's forecast Core Tier 1 ratio, liquidity ratios etc).

3.34 In addition to triggers which will almost always require implementation of the Recovery Plan, firms could also develop some earlier indicators that operate as early warning signals (EWS). These EWS may serve as the starting point for discussions within the firm to allow it to take pre-emptive actions to stem the stress. They may also serve as the starting point for the firm to review its Recovery Plan options.

3.35 Some examples of possible early warning signals are given below (these are not exhaustive):

- the invocation of the firm's contingency funding plan has been triggered;
- negative market sentiment or perception towards the firm, possibly measured by liquid market-based indicators (e.g. widening of a firm's CDS spread relative to peers, unexpected fall in share price relative to peers etc);
- an expectation of a drop in a firm's credit rating; and
- utilisation of a firm's CPB.

Q3: Please give your views on the proposals for the Recovery Plan trigger framework.

4

Resolution planning

SUMMARY

- The Resolution Plan is prepared by the authorities based on the Resolution Pack containing extensive information and analysis provided by the firms.
- Modules 3 to 6 of the RRP Guide explain the work that firms must do. For the Handbook text on Resolution Packs see FINMAR 4.3.
- A key part of the firms' work is a separation or wind-down plan for deposit-taking and other critical economic functions.
- Firms will be expected to identify barriers to resolution and propose changes to remove those barriers.
- The Resolution Pack must be reviewed at least annually and the board will be responsible for ensuring there are processes in place to produce timely and accurate data.
- The Resolution Pack must be updated on an ongoing basis to reflect any material developments in a firm's business.

Purpose

4.1 The aim of the Resolution Plan is to provide a strategy and detailed roadmap to resolve a failed firm or group in a manner that minimises the impact on financial stability without needing to resort to public sector solvency support.

4.2 The Resolution Plan is prepared by the authorities. But for the authorities to have the level of understanding necessary to make the appropriate decisions and implement an effective action plan when resolution is imminent, this requires not only the provision of up-to-date information on the business operations, structures and critical economic functions, but also detailed resolution analysis prepared by firms.

4.3 The authorities need to be able to form opinions on the resolvability of each firm.[17] To enable this, firms will need to provide a significant level of detail and, in particular, the authorities will be asking firms to undertake a 'separability or wind-down analysis' in

17 The G20 and FSB made a public commitment to make significant progress in developing Resolution Plans for G-SIFIs.

relation to each of its critical economic functions. We refer to the information and analysis to be supplied by firms as the 'Resolution Pack'.

Resolution Pack expectations

4.4 The Resolution Pack submission provided by firms will consist of four modules (3, 4, 5 and 6), details of which are set out in the RRP guide. In summary, these modules cover the following areas:

- Module 3 requires details of significant entities in the group and the key structural and operational issues relevant to the separation of significant legal entities.
- Module 4 sets out the key metrics on economic functions to illustrate the relative importance of those functions.
- Module 5 comprises of Critical Function Contingency Analysis (CFCA) covering separation and/or 'controlled wind-down' for each critical function of the firm. The critical economic functions requiring a CFCA will be agreed in discussions between the firm and the authorities after the firm has prepared and submitted Module 4.
- Module 6 refers to plans to overcome any barriers to resolution which the UK authorities consider unacceptable.

4.5 The guiding principle for resolution planning is the maintenance of financial stability. As part of this, the authorities are particularly concerned about the continuation of those economic functions which are deemed critical to the economy and financial system, while at the same time avoiding the protection of shareholders and uninsured creditors through the inappropriate use of public funds.

4.6 In many cases, critical functions are performed by multiple legal entities within a group, often co-mingled with non-critical activities (activities where a sudden or disorderly withdrawal from the market is unlikely to result in a risk to financial stability or a material long-term loss in capacity to deliver financial services to the economy).

4.7 The aim of the authorities will be to ensure the continuity, or the orderly wind-down, of critically important functions at the lowest possible cost consistent with ensuring financial stability. To achieve this objective it may be necessary to transfer some critical functions to one or more third party private sector purchasers, or a 'bridge bank', using the SRR tools. For example, in order to (i) facilitate a sale of certain assets to a third party purchaser, and (ii) identify liabilities that should not be transferred and, therefore, should be left behind in the estate, the authorities will aim to include in the transfer only those assets, liabilities and contractual relationships necessary to facilitate the transfer and, if appropriate, continued operation, of any given function.

4.8 Firms should provide the authorities with the information and analysis including a viable plan on how to separate and disconnect each relevant critical economic function from the rest of the business, whatever legal entity structure the firm has adopted.

4.9 It is impossible to determine the exact tool that will be used by the authorities before the resolution, as this will depend on the circumstances at the time of resolution. Firms should not therefore assume the use of any particular tool when preparing their analysis. The authorities may choose to treat economic functions within legal entities differently, depending on their criticality, and so will need to understand what must be done to separate them and allow differential treatment.

4.10 The authorities will use the information and analysis provided by the firms to prepare a Resolution Plan. This will take a strategic view and will consider which of the SRR tools are appropriate to achieve the plan's strategic objectives. It must be possible for a firm to be resolved in such a way that ensures that shareholders and uninsured creditors bear appropriate losses as they would do in a normal insolvency, rather than benefitting from the immediate need to preserve financial stability or the continuation of essential services as they would do if the firm was bailed out.

4.11 The legal entity structure of a group will also affect the way in which the SRR toolkit can be applied to resolve critical economic functions. For this reason, alongside information and analysis on economic functions, the authorities will also need information on legal entities (for example, whether the entity has a deposit-taking licence, what financial, operational and personnel interdependencies there are with other legal entities, and analysis of how the dependencies would be dealt with on separation).

4.12 In addition to focusing on the individual economic functions provided by firms, it is also necessary for the authorities to consider the potential impact on other firms, markets and infrastructures of a disorderly wind-down of a firm's assets and liabilities, and how this could affect the resolution strategy. Therefore the authorities will also need information on the inter-linkages within and between firms, on both sides of the balance sheet.

4.13 In order to preserve financial stability the authorities may need to resolve firms over a very short period of time, for example, over a single weekend. This requires that any barriers to resolution are identified during the preparation of the RRP and, where possible, eliminated well before resolution becomes imminent.

4.14 Although there is frequent reference in this document to UK economic functions and the importance of ensuring that functions critical to the UK economy and financial system are capable of being resolved in an orderly manner without cost to the UK taxpayer, this does not mean that for international groups we will only be concerned with UK activities. It will be important that RRPs for international firms cover all significant entities in the group, both in the UK and internationally.

Group structure and key legal entity information (Module 3 of the RRP guide)

4.15 This module should provide an overview of the legal structure of the firm and the consequences for resolution. It should explain how capital and funding is allocated and managed across the firm, and the dependencies between different legal entities in the group including any interaffiliate funding and/or guarantees.

4.16 The information required is set out in the templates in the RRP guide and is largely self-explanatory. However, we set out in the remainder of this section more detailed explanations of certain items required in Module 3, which we hope will help firms to provide the information needed. These items are:

i) interbank exposures;

ii) derivatives and securities financing positions and counterparties; and

iii) economic functions.

Interbank exposures

4.17 The recent financial crisis highlighted the importance of understanding the links between financial institutions. In particular regulatory authorities need to understand the interconnections between banks when assessing the implications of bank failure. This is especially relevant when seeking to assess the risk of contagion spreading through the financial market. In order to produce a Resolution Plan for a firm, the authorities need detailed data on its liabilities to other financial institutions. This will inform the authorities of the necessary steps which may be required to avoid contagion and achieve an orderly resolution in the case of the firm's failure.

4.18 The UK regulatory authorities collect interbank exposure data to help monitor the large exposure regime. However, neither the current requirements nor the new large exposure requirements to be introduced as part of the Common Reporting (COREP) framework provide enough detail to give a full picture of the interconnectedness between banks and the subsequent potential for a bank's failure to result in contagion and financial instability.

4.19 To fill this gap, we intend to ask all relevant firms (i.e. those within the scope of the RRP regime in January 2012) to draw up as part of their RRP and submit to the FSA details of their 20 largest interbank exposures using the appropriate template in Module 3 of the RRP guide by the end of March 2012. We would ask firms to complete these templates with data on a consolidated basis for the entity for which the RRP is prepared and the companies in the same group. The template asks for maximum exposures over a six-month period, so this first submission request would be for the period from 1 July to 31 December 2011. Please note we request that this first submission be made before firms are required to have Recovery and Resolution Plans in place. After that, we intend to request such data on a six-monthly basis. In addition, to ensure that we have sufficient data on the interconnectedness of the UK financial system, we would want data on at least six UK-based counterparties for each bank. If these do not appear in the top 20 list then extra counterparties should be added.

4.20 We intend to take a proportionate approach so that the level of detail expected from each firm will depend on the size of the firm. Initially we plan to use the ARROW impact scores as a threshold (requiring more detail from High and Medium-High impact firms). However, as we progress through regulatory reform plans and develop the operating model of the new Prudential Regulation Authority, we will revisit how we implement a proportionate approach.

4.21 The planned templates for the data collection are included in the RRP guide. There is one for High and Medium-High impact firms and another for Medium-Low and Low impact firms. We will be looking for a breakdown of the counterparty exposures into a variety of different instruments at different maturities. In each case we would ask for the peak exposure over the last six months.

4.22 Although it will clearly not be without cost, we expect that this kind of information on counterparty risk exposures should be easily extracted from firms' risk management systems. However, we recognise that systems do differ across firms and that some will find it easier to provide the information in the templates than others.

4.23 The collection of the data would initially be via requests to complete and submit a template spreadsheet. A more streamlined solution will be investigated after the regulatory reform changes have been implemented and various relevant international data initiatives are complete.

4.24 For example, the Financial Stability Board (FSB) has a data gaps working group considering the information that is needed to adequately inform regulatory authorities in different jurisdictions around the world of key risks to international financial stability, and to enable them to effectively apply macro-prudential policy tools. It is likely that interbank exposure data will form part of the data set required by the FSB when this work is finished. We will revisit this template once the FSB work is complete in order to avoid duplication for banks that are required to complete both.

4.25 At a European level we will be monitoring the interaction with the data gathering initiatives of the European Systemic Risk Board and also the European Commission's COREP[18] initiative, with a view to ensuring this data collection is consistent with those work programmes, there is no unnecessary duplication, and we are not inadvertently imposing stricter requirements than any maximum harmonising EU directive or regulation.

Q4: Do you agree it is appropriate for the FSA/PRA to collect interbank exposure data as outlined? What changes, if any, would you suggest to the data template?

18 Common Reporting (COREP) is the term used to describe harmonised European Capital Requirements Directive reporting, which will be mandated by the European Banking Authority as a standardised reporting framework from 31 December 2012.

Derivatives and securities financing positions and counterparties

4.26 Derivatives or securities financing books provide unique and difficult resolution challenges. It is apparent from the Lehman Brothers failure that leaving a large trading book in administration can result in a disorderly unwind which destroys value and compounds turbulent market conditions. Derivatives books are often complex and change frequently. They can be difficult to produce aggregated information on a legal-entity basis, especially in short order. In a resolution where the partial transfer powers are used, the resolution authority would need to determine (probably over a resolution weekend) whether and where to transfer each counterparty and, if transferred to a bridge bank, how to manage that position.

4.27 In order to attempt to address the complexities referred to above, the resolution authority will need detailed information on the derivatives and securities financing positions of the firm, by both position and by counterparty. The RRP guide (section 3.7 and associated tables) sets out the proposed information requirements for both derivatives and securities. This data would not need to be produced on a regular basis by firms, but would be required within the initial RRP submission, and the ability to generate the data in short order would need to be demonstrated to the resolution authority from time to time (e.g. annual updates to the RRP). Updated data may be requested at appropriate intervals as part of contingency planning ahead of a potential resolution, for example when a firm moved to Stage 3 or 4 of the PRA's Proactive Intervention Framework, and would need to be refreshed as soon as possible (within hours) after the close of business, before the resolution is undertaken.

4.28 We need to consider the best way for such data to be transmitted to the UK authorities, and would invite views on that. To facilitate ease and speed of assimilation, it would clearly help if data was provided to the authorities in a consistent format, but there may also be advantages – particularly with respect to firms with large trading books – for the authorities to gather data and information 'on site' at the firm, using the firm's own systems.

4.29 In order to make it easier to understand the flow of trades through a firm's systems, we are requesting a high-level map of systems used for the booking and settlement of derivatives and securities financing transactions, including the high-level links between these systems. For the avoidance of doubt, this request is to enable the understanding of the location of trade data on the firm's systems, rather than to obtain detailed IT infrastructure information.

4.30 We are also mindful that there could be advantages (to both firms and authorities) in coordinating such data collection internationally in the key trading centres in which a firm operates, and will seek to explore this with other international regulators, including through Crisis Management Groups.

4.31 Separately, we will request information to establish the size of the derivative and securities financing books, as set out in the RRP guide, Module 4, Tables 1 and 2. This is to determine whether derivatives and securities financing might be considered critical for the purposes of Module 5. Within Module 5, where derivatives or securities financing are critical economic functions, information is requested in relation to wind-down costs (see the RRP guide, 5.5.1, 5.5.2 and 5.5.3 and associated tables).

Q5: Please give your views on the suggested information requirements for both derivatives and securities financing, the ability of firms to produce the information quickly (recognising that some modifications to systems may be needed) and comments on whether it would be possible to achieve the same ends through alternative means.

- Specifically, we welcome feedback regarding the appropriateness of individual data fields. To what degree is there variation in the documentation in place, particularly for exchange traded trades? Are there other pieces of data that firms consider would be of use to understand the derivatives or securities financing position?
- We would also welcome feedback on the proposed frequency of derivatives data collection, and feasibility (and preferred method) of delivering potentially large quantities of data, including the possibility of the authorities collecting data 'on-site' ahead of resolution. Please detail where there may be fields where data would need to be provided separately to the main data tape, for example, in a different format.
- We invite feedback on the suggested information requirements for both derivatives and securities financing, the ability of firms to produce the information quickly (recognising that some modifications to systems may be needed) and comments on whether it would be possible to achieve the same ends through alternative means.

Economic functions

4.32 Economic functions refer to the services delivered by a firm and will not necessarily correspond directly to legal entities within a firm's group structure or to the business units operated by the firm. Firms should explain how the economic functions they provide map to the business units through which the group organises itself. In turn it will be necessary to understand how these business units map to the legal entity structure of the group.

4.33 To illustrate this further, the financial services sector provides three high-level services to the real economy:

- payment services, to facilitate transactions between agents in the real economy;
- intermediation of credit and capital, to allow agents in the real economy to save, invest and borrow efficiently; and
- risk management products and services, to facilitate risk pooling and protect agents against adverse events.

4.34 These high-level services can be broken down into separate economic functions which firms perform. For example, (i) current accounts facilitate the provision of payment services; (ii) mortgage lending contributes to the intermediation of credit; and (iii) market-making activities contribute to the provision of risk management. Sometimes, an economic function may support the provision of more than one of the high-level services to the real economy.

4.35 Examples of economic functions are as follows:

- retail current accounts including overdrafts;
- retail savings/time accounts;
- retail lending: mortgages/other secured;
- retail lending: unsecured personal loans;
- retail lending: credit cards issuance and underwriting;
- corporate deposits;
- corporate lending;
- long-term capital investment;
- credit card merchant acquiring/services;
- payment services;
- clearing services;
- cash services;
- third-party services;
- derivatives;
- securities financing;
- trading portfolio;
- equity and debt capital markets;
- asset management;
- brokerage;
- custody services;
- prime brokerage and related securities services;
- general insurance, re-insurance, underwriting and/or broking services;
- life, pensions, investments and annuities;

- corporate advisory services; and
- research.

4.36 There are further details in the table in Module 4 (the RRP guide), which describes these illustrative economic functions and gives examples of the kind of metrics that could be used to assess the importance of each.

4.37 As well as economic functions within the UK itself, firms should also consider economic functions outside the UK that are run through branches of UK entities. Firms should also consider services provided by legal entities abroad that support UK economic functions.

Q6: Please give your views on the list of economic functions list. For example, have we failed to identify any important economic functions?

UK Economic Function Identification Matrix (Module 4 of the guide)

4.38 Preparation of the UK Economic Function Identification Matrix is intended to provide an overall picture of the economic functions operated by the firm in the UK in order that the firm and the authorities can assess (i) which may be critical to UK financial stability, and (ii) which will require a Critical Function Contingency Analysis to be prepared by the firm.

4.39 A 'critical economic function' is a product/activity of the firm whose withdrawal or disorderly wind-down could have a material impact on the UK economy or financial system. A critical UK economic function does not necessarily have to be run from an entity which is domiciled in the UK. Non-critical functions would not need to be continued in a resolution scenario.

UK Critical Function Contingency Analysis – CFCA (Module 5 of the guide)

4.40 Preparing a contingency analysis – as outlined in this module – will enable the 'unplugging' of critical economic functions from other parts of the firm through the authorities applying appropriate resolution tools (usually sale/transfer to a private sector purchaser, transfer to a bridge bank or wind-down).

4.41 After identifying the economic functions it provides to the UK economy, each firm will discuss with the authorities which functions are critical and agree those which require a CFCA. Each CFCA will analyse how that particular critical economic function can be separated, while either preserving continuity of the function or winding it down in an orderly fashion, depending on the nature of the function. This analysis should identify barriers to early resolution (e.g. 'over a weekend'), and suggest ways to deal with those barriers.

4.42 A small and relatively uncomplicated firm may only have two or three critical functions (for example customer deposit-taking, current accounts, mortgage lending), while a large and complex organisation may have more critical economic functions that require separate analysis.

4.43 The authorities consider that any economic functions which support one or more of the high-level services above could be judged to be 'critically important'. Any given firm's provision of an economic function is more likely to be considered critically important if that firm provides a material proportion of total system capacity and/or there are few or no other firms which would be willing and able to step in as substitute providers.

4.44 For certain economic functions it is important to ensure an uninterrupted stream of service provision – for example, the payment services provided by the provision of current accounts, or the making of markets critical to the functioning of the UK financial system. For other functions (e.g. term lending to small and medium-sized enterprises or households), a temporary interruption to the flow of services may be acceptable provided that capacity is maintained in the medium to long term. The authorities will bear this in mind when assessing the submissions provided by firms.

4.45 The requirement for CFCAs recognises that simply providing data will not be sufficient to ensure timely and effective resolution should a firm fail. Preparing the CFCAs will require significant work and analysis by firms, but offers them the opportunity to demonstrate how orderly resolution of key economic functions can be achieved without more drastic measures being required in advance.

Barriers to resolution (Module 6 of the Guidance Pack)

4.46 Planning for the separation and/or wind-down of critical economic functions should enable firms to identify structures, practices or processes that could inhibit the orderly and effective resolution of the firm. We give examples of such barriers in Annex 5 of the CP/DP annexes. As explained in Module 6 of the RRP Guide, we will expect firms to identify barriers to separation or wind-down of critical economic functions in resolution, agree those with the authorities, and propose and agree ways of eliminating them.

4.47 For each possible solution to the barriers to separation or wind-down in resolution, we will expect firms to consider the effectiveness, timing and costs, and give the option they prefer.

4.48 Preparative actions might include actions to reduce the riskiness of the firm, such as simplification of intra-group relationships, changes in contractual arrangements, increased stand-alone capacity, changes in corporate structures and operational set-ups to facilitate separation of certain functions.

4.49 This will be an essential input to the authorities' assessment of whether a firm is resolvable. An important part of this assessment will be the determination of whether critical functions, the separation or wind-down of which could cause instability or dangers to the smooth operation of the UK's financial system, can be resolved without cost to the taxpayer and without disruption to the services needed by the consumer and the wider economy.

4.50 This module may also encompass testing of the feasibility of resolution plans which demonstrate the extent of the barriers identified. This is an area where the use of skilled persons reports under section 166 of FSMA may be appropriate.

4.51 In Module 6, firms can also propose changes for the authorities (and other parties such as payment systems providers) to make to help remove barriers to resolution.

Q7: Please give your views on the proposals for the provision of information and analysis on:

- group structure and legal entities;
- economic functions; and
- barriers to resolution.

Relevance to small firms

As explained in paragraphs 1.16 to 1.18, the rules on RRPs will apply to all UK deposit-takers, regardless of size, as well as certain investment firms. We do, however, believe there is a degree of 'natural proportionality' as the rules will be easier for small firms to comply with than for more complex firms.

Module 1 covers the overview and governance of the plan. We expect that the governance for small firms will be much simpler than for the larger firms and will consist, principally, of ensuring they have a crisis management governance framework in place.

While we expect small firms to think through their recovery options and prepare a Recovery Plan (as set out in Module 2), small firms will have a much more limited number of options available to them and therefore their plans will be shorter.

Similarly, for Module 3 (group structure and legal information), many of the questions (e.g. on the use of branches and subsidiaries, intra-group guarantees, details of derivatives portfolios) will either be not applicable or will only require a very brief factual answer.

Module 4 requires making an assessment of the impact that the cessation or failure of the firm would have on UK financial stability – again, a much easier task for smaller firms and something that, for many of the smallest firms, could be dealt with by a discussion with their regulatory supervisors.

Module 5 concerns preparation of separation plans for deposit-taking and other critical economic functions. While we expect that all deposit-taking firms will have to prepare a Critical Function Contingency Analysis for their deposit-taking function, it may well be that for most small firms this is the only plan which the authorities will require.

In summary, while we expect smaller firms to review the guidance, some parts will be not applicable. Other parts can be answered with brief factual information. We suggest that small firms discuss with their supervisors the most appropriate way of complying with the guidance.

5

Processes and general policy

SUMMARY

- The Recovery Plan and the processes for producing Resolution Pack submissions require board approval.
- Executive board member to be designated RRP executive director.
- RRPs to be updated when necessary and at least annually.
- Details of RRP submission process.
- RRP preparation for global financial institutions.

Firms' internal approval process and sign-off

5.1 Firms will have different forms of internal reporting and governance and the approval of RRPs should fit within a firm's individual processes.[19] However, it is appropriate to require a minimum level of sign-off.

5.2 We believe, as a minimum, the Recovery Plan should receive annual board approval to ensure visibility, ownership and agreement at the highest level in the firm.

5.3 Resolution information and contingency analysis for critical functions included in the Resolution Pack is likely to be a more detailed process than the preparation of a Recovery Plan and is not necessarily appropriate for sign-off by the most senior levels of the firm. However, the board of a firm will need to ensure that there are procedures in place to produce timely, accurate and up-to-date resolution information and analysis when required. We expect that the board will assess, approve and oversee this process annually (although the directors may choose to delegate this responsibility to the audit committee).

19 As with Chapters 3 and 4, this chapter does not relate to the CASS RP. See Chapter 6 for more details on the CASS RP arrangements.

RRP executive director

5.4 It is proposed that firms nominate an executive director who will have responsibility for the firm's RRP. This should be an additional responsibility of an existing executive board member (and therefore an FSA approved person). We believe the RRP executive director should provide a clear point of responsibility and authority for RRP production, maintenance and implementation, as well as emphasising the importance of RRPs. We would expect that the nomination of the RRP executive director will be discussed with normal supervisory contacts under the normal principle of open dealings with us. We would also expect that the director responsible will be identified in the section of the RRP dealing with governance around development and maintenance of the RRP.

Q8: Do you support the proposal to assign responsibility for RRPs to an executive director of the firm?

Ongoing maintenance of data by firms

5.5 It will be important that, while preparing the initial RRPs, firms plan for their regular maintenance and update. This will be a less onerous task than the initial preparation of the plans and, if systems for capturing and recording data are properly established, particularly for resolution information, this should help the firm to provide updated information quickly and efficiently when required.

5.6 A firm should review its Recovery Plan at least annually and when it has been through a major reorganisation, especially when it involves an acquisition or disposal. The plans should also be refreshed whenever the firm looks likely to encounter a severe stress situation and on request from the FSA.

5.7 The Resolution Pack requires firms to provide and analyse data and information and to identify barriers to resolution. Much of the updating of this data and information will be facilitated by suitably improved and adapted systems, although firms will not be required to maintain an ongoing data room accessible by the authorities.

5.8 Firms should have systems and processes capable of providing resolution information on request by the authorities. Resolution information should be updated at least annually to ensure that it can be produced readily if and when required.

Submitting RRPs to the FSA

5.9 There will be an initial implementation period during which firms will be required to prepare and submit their RRPs to the FSA.

5.10 After a short initial review of the plans and information (with the aim of identifying and informing the firm of any major deficiencies), we intend to carry out detailed reviews

during 2012 and beyond. We will do this in a phased way based on our assessment of the risk which firms pose to our statutory objectives.

5.11 The short initial review of RRPs mentioned above will be of modules 1 to 4 inclusive. Where possible at the time of our initial review (especially where smaller firms have submitted their RRPs early) we will also discuss with firms the critical functions required under Module 5. However, in the case of larger firms, such discussions will require more detailed analysis and may take longer to conclude. Following these discussions firms will prepare Module 5 (CFCAs).

5.12 The preparation of CFCAs will help to identify significant barriers to resolution and, after agreement of these with the authorities, firms will prepare the information required in Module 6.

5.13 Once all of the modules for the initial RRPs have been prepared, discussed and accepted, a process will be implemented that allows the FSA to ensure that RRPs are updated regularly and continue to be fit for purpose. We propose that reviews are built into the ARROW process (and the supervisory review process that replaces it in the PRA), which will ensure regular review on a staggered basis and will cover the higher risk firms more frequently than smaller or lower risk firms. However, RRPs will need to be available on demand and will be requested on this basis as necessary and on a test basis from time to time.

5.14 The Omnibus 1 Directive (Directive 2010/78) makes changes to the Financial Conglomerates Directive, among others. These changes, in part, relate to recovery and resolution plans and must be reflected in FSA rules by 31 December 2011. Specifically, article 9 of the Omnibus 1 Directive requires member states to require regulated entities to have, in place at the level of the financial conglomerate, adequate risk management processes. Those processes must include: 'arrangements in place to contribute to and develop, if required, adequate recovery and resolution arrangements and plans'. Readers should note that the FSA will consult, as is required, on the transposition of article 9 in the September 2011 Quarterly Consultation paper. The rules that will substantively provide, however, in relation to recovery and resolution planning are, of course, being consulted on in this consultation paper

Approach to preparing RRPs for global financial institutions

5.15 The European Commission's Communication of October 2010 sets out a general framework for a comprehensive EU framework for troubled and failing banks.[20] In addition to our response to the European Commission's consultation on *Technical details of a possible EU Framework for Bank Recovery and Resolution*[21], this section explains how we intend to develop our policy and rules for using RRPs to develop a recovery and resolution plan for a global financial institution.

20 *An EU Framework for Crisis Management in the Financial Sector* (20.10.2010).

21 DG Internal Market and Services Working Document, *Technical Details of a Possible EU Framework for Bank Recovery and Resolution.*

5.16 Where we are the home regulator, Recovery Plans will need to take account of the overseas subsidiaries of a UK deposit-taker as part of the group's business even though they are regulated by overseas regulators. For UK headquartered groups, firms should submit a group-wide Recovery Plan. When appropriate the group plan will be complemented by local Recovery Plans for the subsidiaries developed in conjunction with local supervisors in order to provide the most robust planning possible.

5.17 On resolution, the European Commission communication proposed that group-level resolution authorities should be responsible for drawing up and maintaining group resolution plans in cooperation with the other resolution authorities concerned. As stated in our response to the European Commission's consultation on *Technical details of a possible EU Framework for Bank Recovery and Resolution*, we share the Commission's desire to explore ways in which the group-level resolution authority could coordinate resolution planning. However, the UK view is that, in actually carrying out a resolution, each national resolution authority must remain ultimately responsible for the legal entities incorporated in its jurisdiction.

5.18 We agree, however, 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 elsewhere in the EU. In particular, the group-level resolution authority has an important role in coordinating work to identify barriers and risks to different resolution options and understanding the likely cross-border impacts and interdependencies of national-level resolution actions. This preparatory work is necessary to arrive at a position where a coordinated resolution is a realistic prospect, as well as helping to strengthen the mutual understanding and trust necessary to execute such a resolution effectively.

5.19 Coordination by the group-level resolution authority during a resolution could imply the following types of action:

- facilitation of information exchange;
- coordinated provision of liquidity support across home/hosts;
- maintaining operational inter-dependencies between dependent entities in different jurisdictions;
- gearing up to provide information to depositors e.g. on how home state schemes will treat policyholders resident abroad – this may include communications to depositors and handling of applications for compensation;
- resolution communications and strategy, e.g. synchronized announcements, avoidance of conflicting statements, and use of common language; and
- where appropriate, coordinating the imposition of losses on creditors by different resolution authorities through conversion/write-downs should instruments sit in a number of jurisdictions.

5.20 In summary, on resolution, we are supportive of working towards a more universal[22] approach to resolution planning in the longer term, but we recognise that it will take time to coordinate this internationally. In the meantime we will adopt a practical approach to international groups whereby home and host authorities share resolution and information-gathering responsibilities and we develop group resolution plans underpinned by coordinated resolution action.

5.21 From a home regulator perspective we will coordinate the resolution plan with host authorities (who have the power to apply their resolution powers to the operations of locally incorporated entities within their jurisdiction) with the aim of developing group-wide compatible resolution plans. Home and host authorities should work closely through cross-border crisis management group meetings to discuss and amend the resolution plan. In some cases, this will require host authorities requesting the contingency analysis for critical functions carried out in their jurisdictions. Accordingly, a firm could be asked to supply information both to the home regulator and the host regulator.

5.22 The European Commission will adopt later this year a legislative proposal for a harmonised EU regime for crisis prevention and bank recovery and resolution. In addition, the FSB is expected to release its final views on the essential elements of RRPs for G-SIFIs (Global Systemically Important Financial Institutions) in November. We will review our approach again once the European Commission and FSB proposals have solidified. This will help us in formulating our domestic policy.

5.23 In order for home-host cooperation to be effective and coordinated, information sharing needs to take place. Without this, there is potential for much duplication of effort and development of incompatible recovery and resolution planning. We intend to share appropriate RRP information to achieve this outcome unless it conflicts with our regulatory objectives.

5.24 The determination of what is appropriate to share with international regulators will reside with the UK authorities (subject to appropriate gateways[23]), as the parties assessing the robustness of the firm's Recovery Plan and using the data and analysis to develop resolution plans.

5.25 For branches of foreign firms located in the UK we would expect that the relevant sections of RRPs will be made available to us by home regulators as we intend to do regarding branches of UK firms located overseas. We regard evidence of acceptable RRPs being in place as an important condition for firms to be able to establish and maintain branches in the UK and hope that this approach will be established as part of the EU's work on crisis management.

Q9: Do you agree with the above approach for the preparation of RRPs for internationally active firms?

22 This could include a single group-wide resolution tool for resolving the group.
23 As set out in FSMA and the FSMA (disclosure of confidential information) Regulations 2001 (SI 2001/2188).

6

CASS Resolution Pack

Introduction

6.1 The development of the Recovery and Resolution policy framework includes a resolution proposal focused on reducing the impact of firm failure, specifically in relation to investment business client money and custody assets (CMA). This area of resolution policy is referred to as the 'CASS Resolution Pack' (CASS RP). CASS is the FSA's Client Assets sourcebook, the section of the Handbook setting out rules that provide regulatory protection for CMA, where financial firms are responsible for looking after clients' CMA.[24]

6.2 In this chapter, reference to 'policy' refers to the CASS RP unless otherwise indicated. Linked to this document is a draft instrument relating to proposed additions to the CASS section of the FSA Handbook.

Who should read this chapter?

6.3 The policy proposals in this chapter apply to all firms holding safe custody assets and/or holding client money (together, client money and assets, CMA) in relation to investment business. The proposals in this paper do not apply to firms that only hold client money in accordance with CASS 5 (the client money rules for insurance intermediation).

6.4 The firms in scope for the CASS RP will therefore include some firms that are in scope for our RRP policy, as set out in the rest of this CP, and some that are not. For firms that are in scope for both the CASS RP, and for the proposed RRP requirements, the CASS RP is intended to apply alongside those RRP requirements, as part of the FSA's wider Recovery and Resolution policy framework.

6.5 The CASS RP will apply on a legal entity basis.

24 Where CMA are subject to title transfer arrangements where the firm transfers ownership of those CMA to itself, those CMA will cease to enjoy the protections provided by CASS. Once a firm has transferred the title of those CMA the client will no longer have a proprietary claim on those CMA.

Introduction and policy rationale

6.6 The CASS RP aims to reduce the wider economic cost of firm failure by promoting the swifter return of CMA to clients. The policy aims to deliver this outcome by ensuring that information and records that would help an insolvency practitioner (IP) or resolution authority[25] return CMA to clients more quickly would be accessible *to the IP* after the firm's failure.

6.7 The CASS RP addresses the lack of incentive a firm has when it is a 'going concern' to ensure that information that would help an IP to return CMA more speedily will be accessible to the IP, once the firm has become a 'gone concern'. Problems in an IP's assessment of the firm's CMA positions, caused by difficulty in accessing relevant records, are likely to lead to delays in the return of CMA to the firm's clients. If a firm holding a large amount of CMA fails, there is a real risk that a delay in the return of CMA could damage market confidence and pose risks to financial stability via contagion if uncertainty about the timely return of assets is widespread, and delays cause liquidity strain for clients.

6.8 The insolvency of Lehman Brothers International (Europe) (LBIE) provides an example of the consequences that can flow from delays in the return of large amounts of CMA held by a large institution. Many of the problems with the return of CMA from LBIE were caused by the firm's lack of compliance with CASS, and the return of CMA from such a complex business should always be expected to take a certain amount of time. However, many other problems and additional delays were caused by the IP's difficulty in finding and accessing those CMA documents that were present. This shows the importance of reliable record retrieval and accessibility after a firm has become a gone concern. With any firm, delays in the return of CMA mean that the pool of client property will incur higher costs associated with the insolvency than would otherwise have been the case. This means that delays in the return of CMA may well lead to client detriment and loss, whether or not there is a threat to financial stability/market confidence in any particular situation.

6.9 In aiming to speed up the return of CMA, the CASS RP seeks to achieve the same outcome as, and complements the operation of, the new Special Administration Regime (SAR). The SAR is a modification to UK insolvency law for firms doing certain investment business activities, including the holding of CMA. The SAR promotes the swifter return of CMA by requiring the IP appointed under the SAR legislation to work toward new objectives, including one requiring the IP to ensure the return of CMA as soon as is reasonably practicable. It will also potentially help by giving a SAR-appointed IP the ability to set a bar date for CMA claims. The CASS RP is also part of a wider framework of measures that the FSA is taking to strengthen the regulatory framework for CMA, including the measures set out in PS10/16.[26] Taken together, these measures are designed to strengthen the regulatory framework for CMA, deliver better outcomes for consumers and enhance confidence in UK financial markets.

25 For the rest of this chapter we use the term IP to designate insolvency practitioner or resolution authority.
26 Policy Statement 10/16, *Client Assets Sourcebook (Enhancements)* Instrument 2010

6.10 Ultimately, by aiming to reduce the impact of a firm's failure, the CASS RP will also contribute towards the wider policy objective of the proposed Recovery and Resolution policy framework – a reduction in the wider economic costs caused by the 'too big to fail' problem. It is possible that concerns about whether, or how quickly, large amounts of CMA could be returned to clients could lead the authorities to conclude that they had no choice but to intervene to prevent a disorderly failure, in relation to a given firm.

6.11 The CASS RP does not address 'recovery' considerations. Nor does it attempt to improve the CMA segregation arrangements provided by a firm for its clients. Protections in this area are already provided by existing CASS rules.

6.12 We have not proposed that this policy should apply to insurance intermediaries holding client money under CASS 5 at this time, due to the CASS 5 review that we are presently carrying out. During the CASS 5 review we intend to consider whether equivalent provisions should be included in CASS 5.

Q10: Do you agree with our stated policy objective, which is to promote the speedier return of client money and assets?

Q11: Do you agree that we should establish a CASS RP to help achieve this objective, and to contribute toward better outcomes in general?

The proposals – high level

6.13 We propose that in-scope firms will be required to keep certain new and existing documents and records relating to CMA in such a way that these documents and records can be retrieved within 48 hours while the firm is a going concern, as well as when the firm has become a gone concern.

6.14 The documents to which firms will be required to apply the above accessibility requirements, under the proposed policy, are categorised into two sections, 1 & 2:

- Section 1 documents – new documents/information items which are not currently required by existing Handbook rules. The new items are either signposting documents, pointing the IP to the location of the firm's CMA information and records, as required under the proposed rules, or alternatively documents providing important firm-specific and CMA information that would be helpful to an IP.
- Section 2 documents – these documents, which relate to a firm's client money and asset activities, will exist already as required by existing Handbook rules, if those existing rules already apply to a given firm. The effect of the proposed policy is to require firms to ensure that these documents can be retrieved, whether the firm is a going or gone concern, as set out above in paragraph 6.13.

Please see Annex 4 for more detail on the proposed requirements and the documents falling within the scope of the policy. Further CBA considerations and analysis is found in Annex 1.

Q12: Do you have any comments on the proposed policy, as set out above, and in Annex 4 of the CP/DP annexes?

Q13: Do you agree that the CASS RP will contribute to promoting the speedier return of client money and assets?

Europe

6.15 We have begun to engage with the Commission on these proposals, and will take any necessary steps to ensure that this policy is compatible with European law.

Next steps

6.16 We propose that the CASS RP rules should come into effect six months after the date on which they are made. The publication of the Policy Statement for this (the CASS RP) policy will follow shortly after the rules are made.

Discussion Paper (DP)

7

Introduction

7.1 The data and analysis provided by firms as set out in the CP will not ensure that firms are resolvable. The information provided will greatly help to identify barriers to resolution but it will take further action by both firms and the authorities to overcome these identified barriers.

7.2 This DP explores different approaches to removing barriers to resolution and enhancing resolvability.

7.3 Firstly, we discuss possible regulatory approaches to enhancing resolvability. A number of issues relating to our regulatory approach are considered, including our obligation to consider the costs and benefits associated with any change to our rules.

7.4 Secondly, we set out a number of generic obstacles to resolution identified in our pilot work and give possible solutions.

7.5 We are asking you to comment on any area of the DP and to raise additional barriers to those identified and any alternative solutions to those put forward in this paper.

8

Regulatory approach to improving resolvability

8.1 The following chapter outlines some initial thinking on resolvability. Further thinking by the FSA/PRA, with the help of the Bank of England as resolution authority, is needed to help tackle the more practical issues involved in defining and assessing resolvability, drawing on work underway internationally. As part of this development, we would value conversations and feedback on what we have outlined below.

Definition of resolvability

8.2 To be able to identify significant barriers to resolution and develop effective solutions, we need to be clear about what is meant by 'resolvability'. This is essential if we are to expect firms to demonstrate, and the authorities are to assess, whether they are resolvable.

8.3 The FSB has defined resolvability in its July 2011 consultation document as the following: 'A systemically important financial institution (SIFI) is 'resolvable' if it is feasible and credible for the resolution authorities to resolve it without taxpayer exposure to loss from solvency support, while protecting vital economic functions. For resolution to be feasible, the authorities must have the necessary legal powers – and the practical capacity to apply them – to ensure the continuity of functions critical to the economy. For resolution to be credible, the application of those resolution tools would not itself give rise to unacceptably adverse broader consequences for the financial system and the real economy.'

8.4 Resolution policy should aim therefore to work towards achieving at least the following outcomes:

- The resolution of institutions promptly without recourse to public sector solvency support.
- The avoidance of disruption and cost to the public and the economy that could occur from widespread interruption to deposit and/or securities accounts, ensuring continuity in customer-related activities.

- Assurance that shareholders and unsecured creditors (excluding insured depositors) are genuinely exposed to loss and that they bear such losses in reverse order of seniority as would be the case under the insolvency laws. Chapter 11 discusses the case for broader bail-in powers.

Public sector support

8.5 As stated above, the intention of a successful resolution is that it will be carried out without recourse to public sector solvency support (the protection of insured retail deposits through the FSCS will continue, funded by the financial services industry). The type of public support provided in the past, such as injections of equity capital or asset protection schemes, should not be contemplated for the future.

8.6 However, it should be stressed that protection provided by the FSCS will continue, as this is ultimately funded by levies on the financial services industry. One or more central banks may also provide liquidity (on a collateralised basis) to the firm in resolution.

Social cost

8.7 One of the major costs associated with bank failure arises from the disruption of customer activities, such as deposits, payments services, lending, clients' securities activities, or from disorderly market conditions that can be exacerbated by a rapid unwind of a derivatives/trading book. These costs will be higher if payment, clearing and settlement infrastructures are not robust and/or if the deposit guarantee scheme is incapable of paying out insured deposits promptly.

8.8 It is important that, as in normal insolvency, the investors and uninsured, unsecured creditors of a failed bank must remain exposed to the threat of losses. This provides an important market discipline.

8.9 However, there can be circumstances where losses to creditors of a failed firm will cause risks to the UK economy and financial system. The losses faced by creditors could be so great as to threaten confidence in the system or lead to other banking failures and would thus call into question whether the firm is credibly resolvable. This credibility of exposing creditors to losses will be a factor which will be considered when assessing the resolvability of a firm and whether actions need to be taken by the firm for it to become resolvable.

Over a 'resolution weekend'

8.10 The ability to take actions over a short timeframe will be a key factor in assessing the resolvability of a firm. This short timeframe is referred to as the 'resolution weekend' – i.e. the short space of time available, typically while financial markets are closed, before the absence of critical services leads to social disruption, loss of confidence in the financial system or damage to the economy.

8.11 By the end of a resolution weekend the authorities will need to ensure that critical banking services can continue without interruption. The resolution authority may accomplish this though a variety of methods, including without limitation:

- the separation and transfer of critical functions to a bridge bank (leaving other parts of the business to go into administration); or
- the sale of entities and/or businesses containing the critical functions to a third party purchaser.

Regulatory approach to enhancing resolvability

8.12 We expect to proceed step by step in our approach to enhancing resolvability. The first step is to assess, based on its RRP, whether a firm is resolvable.[27] If it is not, then the next step is to look at any actions the firm has identified, and for the authorities to identify further actions which could be taken in order to make the firm resolvable. Those actions may be taken by the firm or by the UK authorities.[28]

8.13 When we consider those actions we will refer to our statutory objectives, including our market confidence and financial stability objectives.

8.14 We will also consult the Bank of England, FSCS, and the Treasury concerning the adequacy of the plans so far as relating to any matter which may be relevant to the exercise of their powers under Parts 1 to 3 of the Banking Act 2009.

8.15 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, we will write to the firm with our views.

8.16 As part of this dialogue, we would expect:

1) To identify, with the firm, those economic functions that the firm carries out which, in our opinion, are 'critical economic functions' (as defined in paragraph 4.39 above).
2) To ask the firm to provide more information as regards to those functions, and in particular what steps could be taken now so that the actions which might be required in a crisis would be more effective. We would also consider whether it would be appropriate to instruct a skilled person (under section 166 of FSMA) to provide more information on the actions that could be taken now and the effect of such actions on the nature and extent of actions which would then be appropriate in a crisis.

27 The *Resolvability Assessments* annex of the FSB's consultative paper on *Effective Resolution of Systemically Important Financial Institutions* sets out a series of questions aimed at assessing the resolvability of firms. The questions cover an assessment of the firm's structure and critical services, the robustness of the firm's RRP, the adequacy and ability to continue management information systems (MIS), the complexity of intra-group relationships, the applicability of resolution powers and the quality of cross-border crisis management planning. This will help in the formulation of our resolvability assessments.

28 The European Commission's recent consultation on bank recovery and resolution included powers for authorities, where they identify obstacles to resolvability, to require a bank to take appropriate measures to ensure that it can be resolved with the available tools in a way that does not threaten financial stability and does not involve costs to the taxpayer.

3) To consider the costs and benefits and overall appropriateness of the firm taking particular actions now that could result in more appropriate actions being taken in a crisis.

4) To ask the firm to take those actions where the FSA considers them to be proportionate and reasonable. That request would, in the first instance, be in the form of a written request to the areas where the RRP fails to make satisfactory provision for the actions which could be necessary to secure the carrying on of the business or the actions which could be taken in the event of the business failing or being likely to fail.

5) We would expect, consistent with Principle 11, to be notified by the firm if it did not propose to take those actions which the FSA considered necessary.

6) Where a firm notifies us that it does not intend to take such actions, or does not take such actions, then we will consider using our powers under the FS Act, for example our power under section 45 to vary on our own initiative, a firm's Part IV permission or our power of intervention under section 196 so as to require a firm to take such actions. This would have regard to: (1) one or more of the threshold conditions; or (2) actions necessary to meet any of the FSA's regulatory objectives; or (3) any notice from the Treasury or the Bank of England that in their opinion a resolution pack fails to make satisfactory provision in relation to any matter. Any such action would, of course, attract the usual safeguards of notice in advance, a right to make representations, and a right of appeal on the merits to the Tribunal afterwards that are associated with the exercise of such regulatory powers.

8.17 In considering the costs and benefits as mentioned above, we would intend to have regard to the timing of those costs. The choice is to some extent between incurring costs now (costs incurred by firms in altering their business operations now may be passed on to consumers who are also taxpayers) and costs later (including the social and systemic disruption costs that are borne by taxpayers when significant firms fail or government support is required).

8.18 The approach above follows the current duties and powers of the FSA and where appropriate we expect to use these powers to start to effect improvements in firms' resolvability. We expect that the approach will be very similar once the PRA is formed and becomes responsible for effecting necessary micro-prudential changes, but we are also conscious that during this transition period, other important changes may be introduced, particularly by the government in response to FSB and Independent Commission on Banking recommendations. We are therefore interested in views on whether our transition approach under existing and proposed regulatory structures could be improved.

9

Barriers to resolution

Overview

9.1 As explained in Chapter 8, the insolvency of a deposit-taking institution can cause serious disruption in essential banking functions and routine financial affairs for individuals and firms, and can have broader adverse effects on the economy as a whole.

9.2 In many cases, the use of the SRR tools provided by the Banking Act 2009 will be in the public interest rather than implementing normal insolvency procedures.

9.3 The SRR has the following statutory objectives:

- to protect and enhance the stability of the financial systems of the UK;
- to protect and enhance public confidence in the stability of the banking systems of the UK;
- to protect depositors;
- to protect public funds; and
- to avoid interfering with property rights in contravention of a Convention right (within the meaning of the Human Rights Act 1998).

9.4 We have undertaken pilot RRP work with the large banks. Through these exercises, and international programmes of work in the FSB and EU, we have identified certain general obstacles to resolution. An overview of these obstacles and their implications are described below and in more detail in Annexes to the discussion paper. The FSB's consultative paper on resolution discusses some of these issues and suggests potential policy responses. The FSB is intending to engage further with the industry to assess their feasibility as policy options once a more concrete set of recommendations has been developed. We anticipate that our views on these matters will be informed by the responses to the FSB's consultative paper.

Trading books

9.5 A substantial derivatives or securities financing book provides one of the most difficult challenges to resolution. In a large bank the complexity and size of the trading book can

make an orderly wind-down costly to finance and very slow to complete as some contracts can last for decades. There can be considerable benefits to preserving value for the estate of the failed bank in preventing counterparties from exercising rights of early termination upon events of default (based upon resolution) for a short period of time (e.g. one day) so that positions may be transferred to a performing third party or a bridge bank, and those positions that remain in the bank administration can be unwound in an orderly manner.

9.6 Given the importance of this subject it is discussed fully in a separate chapter below (see Chapter 10).

Structural barriers

9.7 The legal structure of banking groups can pose barriers to resolution and therefore increase the difficulty and costs involved in effecting a resolution. Resolution may be more difficult depending on: (i) where critical functions are positioned within the group, for example, in an entity outside of the deposit-taker, and so outside the full range of SRR powers; (ii) the nature of the holding company, for example if Temporary Public Ownership would result in the government taking ownership of parts of a group which have no relevance to financial stability (such as non-financial businesses); and, (iii) whether the group uses a branch or subsidiary structure, which will affect the application of SRR powers.

9.8 Complex organisational structures and business models with economic functions and business lines spanning multiple legal entities and brands, as well as the co-mingling of different activities in the same legal entity, further complicate matters for resolution, making it more complex and costly to separate critical economic functions to effect an orderly sale and/or transfer.

See further discussion in Annex 5 of the CP/DP annexes to this paper.

Operational and financial dependencies

9.9 Ensuring the continued provision of and access to services such as IT, data provision, utilities, purchasing etc is important to the successful separation of an economic function in resolution. Critical economic functions may rely on these services and need them to continue during resolution in order to minimise disruption and facilitate a successful transfer, sale or orderly wind-down i.e. deposit payout using SCV or return of client asset aided by the CASS RP.

9.10 The ability to identify quickly and accurately the services received by a critical function and the entities providing those services is crucial to ensuring continuity in the provision of key services in resolution. The location of the service providers may also be important. If the entity providing the services is outside the control of the resolution authority – for example, is not a subsidiary of the deposit-taker or is located overseas – it is likely to be more uncertain whether continuity of services can be assured.

9.11 Finally, deposit-taking groups will have a number of financial dependencies stretching across the group. These, along with operational interdependencies, very often form an intricate web of dependencies among the entities and businesses of the group making the transfer, sale or wind-down of a critical economic function complex, costly and difficult to impose appropriate losses on creditors.

See further discussion in Annex 6 of the CP/DP annexes to this paper.

Q14: Should firms be required to take steps to ensure that services to UK entities containing critical economic functions are covered by effective, insolvency robust service agreements?

Q15: Should the companies which provide such services be required to be capitalised adequately so that they can resist collapse in circumstances of group-wide failure?

Q16: What other steps should be taken to help ensure the continuity of critical banking services?

Booking practices

9.12 The practice of booking the business of one entity in or through a different group entity causes problems in resolution. For example, it may:

- make it harder to ascertain the true balance sheet of each of the group's legal entities;
- provide conflicting incentives for different legal entities within a group in resolution (especially if some of these entities are outside the UK);
- lead to closing out complex netting arrangements; and
- pose ongoing challenges for managing the risk arising from the related underlying businesses, where that risk has been dispersed throughout other legal entities in a group and is managed through services provided by a separate legal entity. This can mean an economic function cannot be separated or at least very costly to separate both for the authorities and for the firm.

9.13 The FSB has covered this issue in its consultative paper and has suggested possible policy responses to mitigate the problems that booking practices may pose in resolution.[29] We will consider the responses the FSB receives to its proposals before deciding what steps should be taken.

29 The proposals are a result of an FSB workstream on intra-group guarantees and booking practices.

Payments systems

9.14 The failure of a deposit-taker may prevent it from making or receiving payments through the payment systems in which it is a member. Large deposit-takers can be significant providers of liquidity in the payments system and of infrastructure to other members. This could mean that a significant number of second tier banks and their customers would be unable to make or receive payments if a large bank failed. Additionally, payment systems are embedded in securities and clearing systems and these involve settlement/payment banks. This potentially magnifies the systemic consequences of failure.

9.15 A solution would be to transfer the business to another member or firm. However, it is currently not feasible to effect a quick transfer where a large number of transfers are involved due to operational and technical limitations of existing arrangements. Other solutions have been proposed but they face challenges and limitations.

9.16 To examine ways to overcome barriers to resolution stemming from a firm's membership in payment systems and schemes, various groups and consultations have been established both internationally (e.g. FSB's CBCM Global Payments Operations and CPSS-IOSCO's 'Principles for FMI'[30] – the latter approaches from the perspective of improving FMI's overall resilience) and domestically (Bank of England, Payments Council, BBA Large Banks Working Group etc).

9.17 The FSB has discussed the obstacles to resolution presented by firms' reliance on membership of financial market intermediaries and suggested potential policy responses as a result of its workstream on Global Payments Operations. We will consider the responses to the FSB's consultation in developing our thinking in this area.

See further discussion in Annex 7 of the CP/DP annexes to this paper.

Clearing and settlement systems

9.18 Similar issues for resolution to those stemming from the failure of payment systems members arise with respect to clearing and settlement. Failure may prevent a bank from clearing and settling transactions and could make the cut-off point for settlement of transactions unclear. To ensure continuity it is critical that a member retains pertinent memberships and is able to access relevant infrastructure or that its business can be transferred.

See further discussion in Annex 7 of the CP/DP annexes to this paper.

30 www.bis.org/publ/cpss94.pdf

Q17: What are the changes to payments, clearing and settlement mechanisms that would allow banks to be more resolvable and would ensure continuity in the provision of vital payment, clearing and settlement functions?

Territorial versus unitary approaches to resolution of branches

9.19 Generally, there are two approaches to international insolvency, the unitary approach and the territorial approach. Under the unitary approach, the bank is resolved as a single entity. All the bank's assets, regardless of their location, are pooled together and liquidated for the benefit of all the bank's creditors, regardless of location. The administration of the estate takes place in the home country under the laws of the home country. Under the territorial approach, each jurisdiction resolves the branch within its territory as if it were a separate, independent legal entity.

9.20 If all the bank's branches are in countries that follow the unitary principle, the introduction of foreign branches does not materially complicate the process or raise the cost of resolution under liquidation. The bank's entire operations are resolved under the home country insolvency proceedings.

9.21 If, however, some of the bank's branches are in countries that follow the unitary approach, and some are in countries that follow the territorial approach, there is a conflict between the two regimes. Effectively, the branch in the country with the territorial approach exercises a preference over the assets in that territory and the liabilities of the branch in the 'territorial' country may experience faster and/or better recovery than similarly ranked liabilities in the rest of the bank. This is much more likely to be the case if the host country imposes capital and/or liquidity requirements on the branch.

9.22 The EU takes a unitary approach to resolution; the United States takes a territorial approach as regards banks. So any non-US bank with a branch in the United States is prey to this conflict, and practically all large non-US banks have a branch in the United States. Often this US branch conducts a significant portion of the bank's overall activities.

9.23 While these differing approaches do not represent barriers to resolution as such, they will need to be borne in mind when planning a strategy for resolution.

10 Trading book

Introduction

10.1 The potential for very serious threats to financial stability to arise from the resolution of a firm with a sizeable trading book is considerable. If such a firm were to undergo a conventional insolvency, direct losses to the shareholders and creditors in the failing firm may be significant, but even more damaging could be the indirect losses to other market participants resulting from the compressed process of liquidation of collateral and consequent adverse market and confidence effects. Even if a Special Resolution Regime applied to the firm, the authorities would still be likely to face difficult decisions and trade-offs concerning the financing and speed of wind-down of a major trading book.

10.2 In this part of the DP we consider some of the issues that will arise in a resolution together with the implications of the different approaches to resolving a large trading book.

Issues arising from Over The Counter (OTC) derivative and securities financing transactions

10.3 Over The Counter (OTC) derivative transactions between two counterparties are typically covered by an industry standard 'Master Agreement', such as the ISDA model.[31] As a result all such transactions between two counterparties will usually be governed by a netting agreement rather than being treated as separate contracts for the purposes of closing out and netting. The termination, valuation and settlement process required is complex and time-consuming when there are large volumes of trades to be reconciled.[32] This is problematic for resolution because of the resource it demands and the uncertainty it generates, as well as disruption to cash-flows across the market generally.

10.4 Additionally, OTC derivatives transactions may be associated with other transactions entered into by the failing firm (e.g. an interest rate swap may 'fix' the interest rate payable on a floating rate loan). This may mean that it is not possible to separate cleanly trading

31 Securities financing transactions (i.e. stock borrowing and lending and repurchase and reverse repurchase transactions) are typically covered by separate industry standard 'Master Agreements' that are similar in their effects to ISDAs as regards netting protections.

32 E.g. Lehman Brothers companies had approximately 1.2 million transactions, with approximately 6,500 counterparties, outstanding at the time of the group's failure.

book activity from non-trading book activity in a resolution; or alternatively, because of safeguards that keep netting arrangements intact in a resolution, it is not possible to keep the trading book activity with its related non-trading book activity.

Issues arising from concentration of trading book activity

10.5 The vast majority of trading book activity is concentrated among a small number of firms, with the largest 14 dealers accounting for some 80% of total notional contract amounts outstanding in the global OTC derivatives markets (in June 2010).[33] Almost all of these dealers undertake a significant proportion of their OTC derivatives and other trading book business in the UK. In the event of a large firm failing this will mean that in a resulting resolution there may be a limited number of buyers for any portfolio of contracts.

Approaches to resolution

10.6 In principle, there are four main approaches to the resolution of the trading book of a failing firm:

1) insolvency;

2) sale or transfer of the trading book;

3) controlled wind-down; and

4) some combination of (1), (2) and (3).

1) Insolvency procedures[34]

10.7 The failure of the Lehman Brothers group in September 2008 demonstrated the risks of relying on a conventional insolvency procedure for a firm with a large trading book. Subsequent claims by OTC derivative counterparties on Lehman Brothers group companies have amounted to approximately $60 billion in excess of those companies' OTC derivative liabilities shortly before the event of insolvency. The claims arise from the counterparties' self-assessment of costs incurred in the close-out netting process, which they are mostly entitled to claim from the defaulting counterparty according to the terms of the governing ISDA Master Agreement. The claims are equivalent to nearly three times the Lehman Brothers group's consolidated equity capital shortly before bankruptcy.

33 The G14 firms, as identified by the International Swaps and Derivatives Association (ISDA), are Bank of America, Barclays, BNP Paribas, Citigroup, Credit Suisse, Deutsche Bank, Goldman Sachs, HSBC, JPMorgan Chase, Morgan Stanley, Royal Bank of Scotland, Société Générale, UBS and Wells Fargo.

34 This could apply in one or two ways. If the UK SRR powers could be applied, the trading book could be retained in a failed bank which is placed in a Bank Administration Procedure, or (perhaps less likely) in a Bank Insolvency Procedure. If the UK SRR powers could not be applied, then normal corporate insolvency measures would follow.

10.8 Perhaps more important than the direct losses imposed on Lehman Brothers counterparties were the indirect losses incurred by other market participants. The combination of mass liquidations of securities collateral by counterparties and the scramble to take out replacement OTC derivative contracts led to generalised downward pressures on many market prices, a ballooning of credit spreads, generalised widening of bid-offer spreads and reductions in market liquidity. Fire-sale valuations transmitted instability to other market participants, who were often obliged to value their own assets and liabilities at latest market prices. Arguably the processes of valuation by non-defaulting counterparties only added to the downward price pressure. This swiftly resulted in a loss of market confidence in some other major firms.

10.9 So while losses being borne by shareholders and creditors in the normal order of insolvency priority would be a consequence of such an insolvency process applying to a failed firm, its entry into insolvency may pose market stability risks.

2) Sale of a trading book

10.10 In theory, the sale of the trading book in its entirety is one possible way of helping to resolve a failing institution. However, large trading books generally have little appeal to potential purchasers due to their size and complexity, which demands a considerable due diligence effort, the time for which may not always be available.

10.11 For example, derivatives products were one of the two business lines (the other being the evidently distressed real estate assets business) that Barclays decided not to purchase, at very short notice, out of the Lehman Brothers distressed sale in September 2008. In practice, entire trading books have usually only been sold as part of whole-firm sales.

10.12 As described above, because of the concentration of trading book activity, it may not always be possible to find a buyer for the whole. And operational constraints and safeguards for netting arrangements may preclude the sale of a trading book in parts.

10.13 Obviously to some extent sales – where possible – can be made more attractive to potential buyers through pricing; the greater the discount the trading book is sold for, the greater the loss to be borne by shareholders and creditors of the failed firm.

3) Controlled wind-down

10.14 A crucial pre-requisite to the controlled wind-down approach to resolving a major trading book is that there should be available to the authorities a means of avoiding the disruptive simultaneous closing out of large volumes of financial contracts, such as those for OTC derivatives and securities financing transactions, that can often be triggered by the initiation of formal insolvency procedures. This may involve the transfer of such contracts to a sound counterparty such as a bridge bank established under the Banking Act. However, this would

have to be balanced against a desire to minimise moral hazard by ensuring that creditors bear losses appropriate to their seniority.

10.15 It is generally recognised that the process of transfer should not allow the authorities any options for selecting out individual contracts with the same counterparty (i.e. 'cherry-picking'), so as to ensure that netting rights for individual counterparties are preserved (as they are under the Banking Act).

10.16 Most large firms will have trading books that span more than one national jurisdiction and controlled wind-down therefore requires cross-jurisdiction legal harmonisation, mutual recognition and regulatory coordination. These and other issues have already been considered in some detail by the Basel Committee on Banking Supervision.[35]

10.17 Assuming that contracts of this type are successfully transferred to a new sound counterparty such as a bridge bank, the resolution authorities will still face some difficult issues. Many securities financing portfolios are significant net borrowers of funds from the markets. Given their short-maturity profile (the great bulk of positions typically mature within three months) a process of natural run-off of these positions could create a significant short-term financing requirement.

10.18 Whilst it may be possible to obtain replacement finance from the market or reduce requirements by selling the securities, the rate at which this can be done will have to take into account both the trade-off between speed and cost of realisation and the possible systemic consequences of any rapid liquidation. Any short-term liquidity support provided by the UK authorities would need to be priced and collateralised appropriately and should not constitute solvency support.

10.19 In addition the authorities, via a bridge bank or private sector purchaser, will need to decide the speed at which they seek to unwind a major trading book, as the quicker the exercise is completed the greater may be the risk of a significant loss, to be borne ultimately by shareholders and creditors. It will not be feasible for the authorities to run books to maturity in their entirety, where they contain long-dated OTC derivatives positions that have many years to maturity (in some cases contracts can have ten years, or even several decades, to run).

10.20 So a quick sale will tend to produce a poorer financial outcome for stakeholders (assumed, ultimately, to be the shareholders and creditors of the originally failing institution) than a slower unwind. Additionally, a poor financial outcome for the stakeholders may itself have systemic consequences and thus be a key factor that dictates the speed at which unwind takes place. For the large dealers, it is not uncommon for their derivative portfolios to have a notional contract value of between 500 and 1,000 times consolidated group equity, so wind-down costs in the region of 10 to 20 basis points of notional contract value would on their own suffice to wipe out group capital. This obviously has implications for a purchaser/

35 See BCBS, *Report and Recommendations of the Cross-border Bank Resolution Group*, March 2010, especially pages 40-42.

bridge bank in terms of the pricing of any transfer of a trading book and the capital they will need to support any wind-down.

10.21 OTC derivatives contracts that are settled bilaterally can be particularly difficult to unwind. The market risks of such contracts can in principle be hedged by taking out an offsetting contract with another counterparty, but the risks can only be completely eliminated in advance of maturity by cancelling the contract with the original counterparty or by novating or assigning the original contract to another counterparty. However, the costs of reducing risk in this way could be significant and outweigh the risk mitigation.

4) Combination of options 1, 2 and 3

10.22 In resolution the authorities are likely to need to use a variety of these approaches depending on the circumstances of the firm. The complexities of individual trading books, the likely funding requirements and the potential for large losses as trading positions are unwound, are just three significant issues which will need to be considered at the time when assessing the benefits of using one or more options.

OTC market developments

10.23 Two market developments may increasingly assist with winding down OTC derivatives portfolios. The first development, which is coming about partly in reaction to regulatory pressure following the recent financial crisis, is the increasingly widespread use of Central Counterparties (CCPs) for the clearing of certain standardised OTC derivatives transactions. Because the original counterparties to a bilateral OTC derivative transaction novate their contract to the CCP as intermediary, it is only necessary for a counterparty seeking to eliminate its exposure to find a new counterparty willing to undertake an exactly offsetting transaction. Once that new transaction has been cleared through the CCP the counterparty's exposure is completely eliminated. The other original OTC counterparty does not need to be involved at all, which is likely to make elimination of the exposure both swifter and cheaper.

10.24 The other development is the growing use of commercial services that arrange multilateral terminations of bilaterally settled OTC derivatives transactions. Such services are, however, most suitable for relatively plain vanilla and liquid transactions. It is still likely to be hard to eliminate the more difficult to hedge basis risks and the exotic and illiquid positions that reside in most large OTC derivatives books.

Summary

10.25 This section of the DP has briefly described some of the issues which can make dealing with a large trading book in a failing firm one of the most difficult and costly areas of a resolution or an insolvency procedure.

Q18: Matters on which we would particularly appreciate views or comments on are:

- alternative approaches to resolving large trading books;
- alternative approaches to the valuation and realisation of collateral which mitigate market instability in the event of an entity with a trading book being placed into an insolvency procedure;
- changes in regulatory or contractual working practices which could make unwinding trading books speedier and less costly (e.g. default rules applied under the ISDA Master Agreement); and
- financing of trading book wind-downs.

However, the above list is not in any way restrictive and we will value all constructive views on improving the outcome of the resolution of trading books.

11
Bail-in

What is bail-in?

11.1 Bail-in usually refers to a process of internal recapitalisation that is triggered once a firm has reached the point of non-viability. Losses are imposed on certain of a firm's direct stakeholders of a firm by a process of 'bailing-in', either by writing down their claims or by converting them to equity. As a result, the firm is recapitalised from within and the need for new capital resources to be provided by the public sector (i.e. a bail-out) is avoided. Bail-in will usually need to be accompanied by changes in the firm's senior management and the adoption of a new business plan that addresses the causes of the firm's failure. But a key objective of the bail-in process is to secure the continued existence of part or all of the firm on a going concern basis. If this can be done then disruption of services to customers of the firm should be minimised, while its shareholders and uninsured creditors are subject to going concern losses rather than the much larger gone concern losses that they would suffer if the firm went into insolvency or liquidation.[36]

11.2 There is currently considerable international interest in the bail-in approach with work being undertaken by, among others, the Financial Stability Board (FSB) and the EU.[37] In the UK, the ICB has highlighted the importance and potential benefit bail-in might bring. The UK authorities seek to progress their own work on bail-in within this domestic and international context. Respondents' views to this section of the DP will help inform our contributions to these important international discussions.

Contingent capital

11.3 One wholly private sector approach involves the issuance of debt instruments that contain a contractually agreed trigger clause specifying the circumstances in which the instrument is either written down or converted into equity. The intention is usually that the trigger is set

36 See paragraph 10.7–10.9 as examples of some of the losses that could be generated in insolvency.

37 The FSB has established a working group to examine the legal and operational aspects of bail-in mechanisms (see *Reducing the moral hazard posed by systemically important financial institutions: FSB Recommendations and Time Lines*, 20 October 2010). The EU's DG Internal Market and Services is currently consulting on a Working Document on *Technical Details of a possible EU framework for bank recovery and resolution*, which includes a consultation on debt write down as an additional resolution tool (see Annex 1 on pages 86 to 92).

'high', so that when write down or conversion takes place that action on its own should be sufficient to restore the firm to health and enable its continuation as a going concern. Because high-trigger contingent capital instruments are intended to operate well in advance of the firm reaching the point of non-viability, they are not, strictly speaking, bail-in instruments, although they share the same objective of restoring the firm to health. The triggers in contingent capital instruments issued to date have usually been based on published regulatory capital ratios, but it is also possible to envisage market-based triggers being used.[38] The UK authorities do not consider contingent capital to be equivalent to bail-in.

Resolution bail-in

11.4 If a firm has deteriorated to the point where it is no longer viable then it can enter into a formal resolution process under the control of the authorities. Two broad conceptual approaches to bail-in as part of the resolution process have been developed, one contractual, the other statutory. The contractual approach relies upon prior issuance of debt instruments that contain contractual terms explicitly recognising that the instruments will be converted into equity, or written down, upon occurrence of a pre-specified point of non-viability trigger event. The statutory approach envisages that once a firm has reached the point of non-viability the relevant resolution authority will select from the range of debt instruments issued by the firm, such as subordinated debt and senior unsecured debt; this selection will be consistent with the creditor hierarchy, for conversion into equity or for write down. In order to ensure continued proper functioning of markets it might be necessary to exclude certain liabilities, such as secured debt, from the list of those that could be subject to conversion or write down.[39]

11.5 Bail-in should be designed with the objective of preserving, as far as possible, the normal priority rankings in insolvency.[40]

11.6 Both approaches have advantages and disadvantages and clearly the statutory approach gives the authorities the most flexibility. However, the contractual and statutory approaches towards resolution bail-in are not mutually exclusive. Indeed, they could be complementary. For example, contractual bail-in might be sufficient to recapitalise a failing firm, in which case recourse to statutory bail-in might not be needed. But in cases where contractual bail-in is deemed unlikely to be able to recapitalise the firm adequately, the statutory power will also need to be exercised.

38 See, for example, Andrew Haldane, *Capital Discipline*, 9 January 2011, at www.bankofengland.co.uk/publications/speeches.

39 For a discussion on this point, see EU's DG Internal Market and Services Working Document, *Technical details of a possible EU framework for bank recovery and resolution*, page 88.

40 For a discussion on this point, see EU's DG Internal Market and Services Working Document, *Technical details of a possible EU framework for bank recovery and resolution*, page 88.

Other considerations

11.7 Resolution bail-in should be aimed at ensuring that the costs of failure are borne by firms and their shareholders, capital providers, and uninsured creditors, rather than the taxpayer. The tool must ensure that sufficient instruments can be written down or converted to equity to ensure an orderly resolution of the failing institution in all cases. So it is essential that the resolution authority is not constrained in advance as to the degree or extent of write-down or conversion when executing the statutory version of the resolution bail-in tool. This is necessary to ensure that the resolution authority has adequate tools to resolve all types of financial institution that are subject to the resolution regime, large or small, when the institution no longer meets the threshold conditions for authorisation and has no reasonable likelihood of meeting those conditions again (including through the use of bonds that write down or convert under contract, whether before or at the time of resolution).

11.8 A risk with both the contractual and statutory resolution bail-in approaches is that there will be an insufficient amount of bail-in-able instruments in a failing firm, as potential lenders and counterparties seek in advance to structure their transactions with firms in such a way that they avoid the future possibility of being bailed in. It may well be necessary to specify both a minimum amount of bail-in instruments and a minimum maturity profile (the latter to avoid the possibility of significant 'runs' on the stock of bail-in-able instruments by counterparties in the event that a firm's financial profile weakens in the eyes of the market). However, firms may wish to issue instead conventional regulatory capital instruments, over and above the applicable regulatory minima for such instruments.

11.9 The Swiss authorities have recently introduced a regime of this broad type for their two largest banks, Credit Suisse and UBS. When the regime has been fully implemented these banks will have to maintain overall capital equivalent to at least 19% of their risk weighted assets (RWAs) as per Basel III. At least 10% of the 19% requirement must be held in the form of common equity and a maximum of 9% may be held in the form of Contingent Convertible Capital (CoCos).[41] But this does not rule out the need for the resolution regime to include a statutory bail-in power. These issues will need to be considered alongside the range of loss absorbency measures currently being discussed internationally.

Triggers

11.10 If a resolution bail-in mechanism was to be introduced in the UK the precise trigger event would have to be defined. An obvious candidate would be the high-level conditions already specified in the Banking Act 2009 for a stabilisation power to be exercised. Broadly, these are:

41 The trigger event specified in the CoCos is breach of a particular measure of regulatory capital. Credit Suisse has recently issued two CoCos that additionally contain a trigger enabling the Swiss authorities to convert them into equity if Credit Suisse reaches the point of non-viability. This gives the CoCos the characteristics of both a purely private sector contingent capital instrument and a contractual resolution bail-in instrument. The addition of a point of non-viability trigger is designed to enable the CoCos to qualify as Basel regulatory capital. It is possible that issuance of dual purpose CoCos of this type could become more widespread.

- that the FSA must be satisfied that the firm is failing, or is likely to fail, to satisfy the threshold conditions for continued authorisation under the Financial Services and Markets Act 2000; and,
- that it is not reasonably likely that (ignoring the stabilisation powers) action will be taken by or in respect of the firm that will enable the firm to satisfy the threshold conditions.[42]

Further support and liquidity

11.11 It would be unlikely that recapitalisation achieved by means of a bail-in would, on its own, restore a firm that had reached the point of non-viability to health and to credibility in the wider market place. At a minimum, the management that had presided over the firm's near-failure would need to be replaced. Other tools in the resolution regime may be used in conjunction with bail-in (either simultaneously or subsequently) if a more fundamental restructuring is required in addition to a recapitalisation.

11.12 A bailed-in firm may require public sector liquidity provision for a period, until it had achieved credibility in the wider market place and could secure funding on normal commercial terms. Public sector liquidity provision would need to be on super-senior terms, to guard against the possibility that liquidity support might transmute into solvency support.

Scope

11.13 Bail-in tools should in principle be considered for all sizes of firm and not just those regarded as systemic. Limitation of resolution bail-in to those firms regarded as systemic could perpetuate the market funding advantages that such firms have enjoyed in the past, but for different reasons. In the past, the advantage stemmed from market perceptions that they were 'too big to fail' and would be bailed out by the public sector. In future, the advantage may stem from the fact that investors in firms subject to a resolution bail-in regime will at worst be subject to going concern losses, whereas investors in firms that are allowed to go bankrupt or that are subject to more conventional resolution tools will suffer far larger gone concern losses.

11.14 Consideration would need to be given to the application of resolution bail-in tools to non-banks. Investment firms with large trading books, which could potentially cause systemic disruption in the event of their failure, would be obvious candidates.

42 See Banking Act 2009, Section 7.

Q19: Bail-in:

- Do you believe that bail-in could be an effective tool in helping to recapitalise a firm that is either at the point of or is failing, in order to avoid a public injection of funds?
- What are the pros and cons of using the various tools: private sector contingent capital, contractual resolution bail-in and statutory resolution bail-in?
- Are the various tools best used separately or in tandem?
- Do you think it will be necessary to regulate the quantum and the maturity profile of bail-in-able instruments if use of the resolution bail-in tools is to be successful?
- Do you see any alternatives to provision of liquidity assistance to a recently bailed-in firm by the public sector?
- Do you think that, as a result of the bail-in arrangements, the cost of capital for banks will increase, or decrease, in a material way? And, what will be the effect on the capital structure?

Associated documents

Documents which should be read in conjunction with this consultation pack include:

- Proposed Handbook text for RRPs and CASS Resolution Pack;
- The RRP guidance pack for firms; and
- Several annexes including the Cost benefit analysis and Compatibility statement.

These documents have been published in tandem with CP11/16 and are important components of this consultation.

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