A DERIVSOURCE Guide to

Living Wills

and Recovery and Resolution Planning

Contents

DerivSource is the online community and independent information source for professionals active in derivatives processing, technology and related services. Founded by a financial journalist, **DerivSource** provides industry news, analysis, educational resources and researching tools to help market participants keep well informed in this fast-paced industry. The content covers both exchange-traded and OTC derivatives.

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Editor's note

Living Wills – what you need to know now

Recovery and resolution planning (RRP) is a part of the fabric of new financial regulation that aims to reduce systemic risk and improve supervisory oversight of the financial markets and market participants. As a G20 mandate, this new regulation will impact financial market infrastructure, including clearinghouses and major market participants globally.

In this DerivSource Living Wills Guide we aim to give our 8k+ readers direct information on this new regulation, how financial institutions and market infrastructure are affected and what compliance requires in terms of documentation and legal processes. As always, and with the assistance of our expert contributor, Michael Beaton of Derivatives Risk Solutions LLC, we are able to provide objective insight into this very timely topic to help our readers stay well informed and ahead of the curve in terms of financial regulation and compliance.

Please share and forward this Living Wills Guide to any colleagues or clients who may need information on this new regulation. And to keep up with changes to regulation as it happens we encourage you to bookmark Michael's blog **"Recovery, Resolutions Plans & Living Wills"**.

And don't miss our upcoming podcast on RRP for clearinghouses so please tune into this audio content to hear from industry experts.

Best wishes,
Julia

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DRS

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Michael is a Managing Partner of DRS. He joined Barclays Capital in 2001 working first as a derivatives lawyer and then as a senior structurer within the Complex Transactions Team forming part of the Equity and Funds Structured Markets trading desk. Here, he specialised in the design and documentation of derivatives linked to mutual funds, hedge funds, equities and indices. Michael left Barclays Capital to join DRS in October 2010 where he has responsibility for the firm's regulatory practice, with a particular focus on Recovery and Resolution Plans, Client Money and central counterparty clearing. Michael has appeared as a panel expert in a number of industry events on such topics as central counterparty clearing and CASS Resolution Packs.

Michael's blog can be found at:
www.recoveryandresolutionplans.wordpress.com

A Brief History of Recovery and Resolution Plans

The requirement to produce RRPs for Systemically Important Financial Institutions (SIFIs) can be traced back to the G20 Pittsburgh summit's final communiqué of September 2009. A direct response to the failures of Northern Rock, Bear Stearns, Bradford & Bingley, AIG, Lehman, RBS and HBOS, among others, it was concluded that:

> "Major failures of regulation and supervision, plus reckless and irresponsible risk taking by banks and other financial institutions, created dangerous financial fragilities that contributed significantly to the current crisis. A return to the excessive risk taking prevalent in some countries before the crisis is not an option."

SIFIs would be required to develop internationally-consistent firm-specific contingency and resolution plans by the end of 2010. Moreover, authorities would be required to establish crisis management groups for major cross-border financial firms, a legal framework for crisis intervention, improve information sharing in times of stress and develop resolution tools and frameworks for the effective resolution of financial groups.

As the name suggests, there are two aspects to recovery and resolution plans. Recovery plans are developed and maintained by individual firms with the role of regulators being to review plan adequacy. The purpose of the plan is to identify a menu of options which can be implemented in order to assist a firm to return to a stable and sustainable condition should it come under severe stress. In contrast, resolution plans are drafted by authorities and require firms to submit detailed information about their business and operational structure. The purpose of a resolution plan is to provide a strategy and detailed roadmap to ensure that a firm is "resolvable" i.e. that it is feasible and credible for resolution authorities to resolve it without taxpayer support whilst also protecting vital economic functions.

Whilst the Financial Stability Board's (FSB) "Key Attributes of Effective Resolution Regimes for Financial Institutions" document, published in October 2011, set the international benchmark for RRP, Europe and the United States have taken the lead in RRP implementation. In May 2012, the Financial Services Authority (FSA) published detailed guidance on RRP in the form of FS12/1. As a result, most large deposit taking firms in the UK will have submitted their initial RRP by the end of 2012. At an EU level, the draft RRP directive was published in June 2012. Once finalised, the majority of its provisions will come into force in 2015, with the exception of bail-in which will be delayed for a further three years. In the US, the first set of recovery and resolution plans required by the Dodd-Frank Act were submitted to The Federal Deposit Insurance Corporation (FDIC) by Global Systemically Important Financial Institutions (GSIFIs) in July 2012.

Although no two sets of regulations are identical across jurisdictions, resolution authorities all tend to have a basic set of powers as defined in the "Key Attributes" including the power to:

- sell a failing business to a private purchaser;
- establish a bridge institution to which a failing firm's business can be transferred pending sale or winding up;
- take control of an institution under resolution and exercise all shareholder rights;
- transfer rights, assets, liabilities and instruments of an institution under resolution;
- separate good assets of a failing institution from bad assets;
- impose a temporary moratorium on the payment of claims; and
- write down or convert unsecured debt into equity.

Now that the legislative foundations for bank resolution are largely in place, the conversation is turning. Discussion is focusing on the positive effects which structural change to the banking industry - in the form of Vickers, Volcker and Liikanen – can have on general resolvability. In addition, legislators are increasingly becoming concerned with the resolution of non-bank SIFIs, specifically insurance companies and financial market infrastructures, with a particular emphasis on central counterparties. Subsequently, attention will turn to the resolution of domestic systemically important financial institutions and even hedge funds meaning that, for the time being at least, the pace of international RRP initiatives shows no sign of abating.

An Introduction to Recovery and Resolution Planning for Financial Market Infrastructure

Background

Broadly, the term 'financial market infrastructure' (FMI) refers to:

- central counterparties (CCPs);
- payment systems;
- central securities depositories;
- securities settlement systems; and
- trade repositories.

FMIs contribute to maintaining and promoting financial stability. However, they also concentrate risk and their disorderly failure could have systemically important consequences. This brings into focus the issues of how to determine the systemic significance of an FMI as well as the design of RRP regimes for FMIs that are determined to be systemically important.

Determining Systemic Significance

The key factors in identifying systemic importance in the context of FMIs are generally considered to be:

- size;
- inter-connectedness; and
- substitutability of services.

Sometimes a distinction is also drawn between FMI which take credit risk and those that do not. On this basis, non-CCP FMIs such as payment systems are generally regarded as being non-systemic in importance on account of the fact that they tend not to have financial exposure to the same degree as, say, a CCP, and because any failure would likely to be of a more operational or technological nature. In contrast, and particularly in light of the move towards mandatory clearing of OTC derivatives, CCPs are usually regarded as the most important type of FMI, often to the point where their systemic significance is assumed. Given their importance and the fact that CCP resolution requires an understanding of all of the issues which are of relevance to FMI resolution generally, CCP resolution constitutes the main focus of this article.

RRP for Systemically Important FMI

RRP for FMIs can trace its roots back to the G20 Pittsburgh summit in September 2009 in which it was declared that all "systemically important financial firms should develop internationally-consistent firm-specific contingency and resolution plans…to help mitigate the disruption of financial institution failures and reduce moral hazard". This was followed in October 2011 by the FSB's "Key Attributes of Effective Resolution Regimes for Financial Institutions" (the "Key Attributes"), which not only set out the core elements considered necessary for effective resolution regimes but also provided sector specific guidance on how these elements apply to FMIs. Subsequently, the high level principles laid down in the Key Attributes were overlaid with more detailed guidance in The Committee on Payment and Settlement Systems and the Technical Committee of the International Organization of Securities Commissions (CPSS-IOSCO) "Principles for Financial Market Infrastructures", published in April 2012 (the "Principles") which identified a number of specific

recovery measures that FMIs should take. By the time of the G20 Los Cabos Summit in June 2012, RRP for FMI had become a major focus, with the leaders' declaration providing guidance on the future timetable for financial sector reform in this area. Subsequent work has included the CPSS-IOSCO consultative report on RRP for FMI published on 31 July 2012, followed swiftly on the 1st August 2012 by HM Treasury's consultation document entitled "Financial Sector Resolution: Broadening the Regime". On the 5th Oct 2012 the EU also published a consultation paper on RRP for non-banks and on 17 Oct 2012 HM Treasury published a summary of responses to its August consultation paper.

Viewed in the aggregate it is clear that the overriding concern in designing resolution regimes for FMIs is to maintain continuity of critical FMI functions. In this context, each of the elements detailed within the Key Attributes continues to be relevant, but the following take on a particular level of importance:

- bail-in;
- transfer of critical functions; and
- suspension of contractual rights.

Bail-in

It is generally accepted that all FMIs should hold minimum levels of liquid resources, above and beyond those held to cover normal participant defaults, in order to ensure an ability to continue to operate as a going concern. The principles suggests that this minimum should equate to at least six months of current operating expenses. Nonetheless, losses could, in theory at least, still exceed available financial resources, meaning that some form of statutory bail-in for the purposes of loss allocation (and also recapitalisation), must also be considered.

Traditional bail-in involves the write-down of existing debt and/or its conversion into equity. Unfortunately, unlike banks or investment firms, most CCPs typically do not issue debt securities, limiting the utility of traditional bail-in as a resolution tool. Moreover, whilst mechanisms such as CCP default funds already exist, these arrangements are primarily concerned with loss-allocation rather than recapitalisation. A number of CCP-specific bail-in proposals have been suggested, particularly focused on the ability to apply a haircut to margin. Each has certain advantages and disadvantages, and can result in a very different distribution of losses, as detailed below.

Bail-in Option	Advantages	Disadvantages
Haircutting of initial margin	• Funds are available for immediate use	• Initial margin levels may need to increase across the board • Possibility that this departs from the principle of 'no creditor worse off than in insolvency' • Does not necessarily follow insolvency rankings • Losses may also fall on the clients of clearing members
Haircutting of variation margin	• Funds are available for immediate use • Does not have pro-cyclical effects for out-of-the-money payors	• Has pro-cyclical effects for in-the-money payees • Possibility that this departs from the principle of 'no creditor worse off than in insolvency' • Does not necessarily follow insolvency rankings • Losses may also fall on the clients of clearing members
Enforcing FMI rules to replenish default funds/make cash calls	• Avoids random allocation of losses resulting from margin haircuts	• Increased pro-cyclicality as all clearing members are called for funds
Specific clearing member liquidity calls	• Avoids random allocation of losses resulting from margin haircuts	• Increased pro-cyclicality as all clearing members are called for funds
Establishment of ex-ante resolution fund	• Avoids negative counter-cyclical impact	• Difficulty in calculating appropriate levels of contribution
CCP right to terminate contracts with non-defaulting clearing members for an amount equivalent to that of the defaulter	• An immediate solution	• Random, and therefore potentially unfair loss allocation • Potential to amplify systemic effect
Issuance of CoCo bonds by CCPs	• Burden would not fall on clearing members	• Uncertainty as to market for CCP CoCo bonds

A number of industry participants have opposed proposals to allow resolution authorities to impose excess losses on a CCP's clearing members. It was felt that this would cause uncertainty, potentially lead to distorted incentives such as the early termination and exit of members, result in competitive disadvantage and could have capital and liquidity implications. In light of this opposition, the UK government has recently decided to shelf its plans in this area. Instead, it intends to establish a requirement that loss allocation rules be made mandatory for the purposes of authorisation as a Recognised clearinghouse within the UK. However, in general, it seems clear that some form of bail-in for CCPs, probably based on the haircutting of margin, will be the norm, as evidenced by the recent EU consultation paper on RRP for non-banks.

Transfer of Critical Functions

There is a general recognition of the difficulty of successfully applying the business transfer tool to an FMI in general and to a CCP is particular, due, inter alia, to:

- the relative lack of firms which could act as alternative providers of a failed FMI's critical operations/services;
- the different nature of an FMI's assets and liabilities;
- operational constraints such as IT system incompatibility;
- competition issues which may flow from ownership structures; and
- national political agendas, such as those currently driving the fragmentation of central clearing of OTC derivatives.

In addition, as the core assets of an FMI (its technical facilities and processes, infrastructure and know-how) do not tend to cause losses in the way a bank's assets might, it is arguable that they do not merit being transferred to a separate 'bad' asset management vehicle under an asset separation tool. All of these factors tend to increase the importance of both bail-in and the bridge institution tools as a method of resolving a failed FMI. This should enable authorities to ensure stability and the continuity of critical services whilst a private sector purchaser is identified, whilst simultaneously avoiding the legal and operational impediments that may arise with an outright transfer to a third party.

Suspension of contractual rights

The ability of resolution authorities to suspend contractual rights is seen as a necessary pre-condition to achieving the transfer, and therefore the continuity, of critical FMI functions. It is recognised that the suspension of payments by an FMI is likely to perpetuate or even amplify systemic risk and could defeat the overriding objective of ensuring continuity of critical operations and services. However, a stay on the termination rights of participants, other counterparties and third party service providers is regarded as an important resolution tool with respect to an FMI, particularly a CCP.

By way of safeguards, the principal of "no creditor worse off than in liquidation" continues to apply. However, with respect to FMIs, this concept should be assessed on the basis of creditor claims as they exist following the FMI's ex ante rules and procedures for addressing uncovered credit and liquidity needs and the replenishment of financial resources.

Conclusion

RRP for FMI is just one of a number of current initiatives focused on entities that could contribute to the build-up or transmission of systemic risk. These include RRP for insurance companies, domestic systemically important banks (DSIBs), investment funds and certain trading venues. However, RRP for FMI is of particular importance given, firstly, the central role played by FMIs (and particularly CCPs) in providing the plumbing for financial markets and, secondly, the emphasis placed on bail-in as a tool in FMI resolution. Bail-in is undoubtedly the most powerful of the resolution tools, capable of delivering immediate and significant results. Unfortunately, the very nature of this power means that, if applied incorrectly, bail-in is just as likely to kill as save. Ultimately, the success of RRP for FMI will lie in striking a delicate balance between the political imperative of ending taxpayer guarantees on the one hand and the economic imperative of securing the financial system on the other. Detailed guidance on the resolution of FMI will begin to emerge in the first half of 2013. At that point, we will have a better understanding of whether the attempts of EMIR and Dodd-Frank to harness the potential of FMIs have merely resulted in the creation of a time bomb, which RRP cannot defuse.


Last Will

HM Treasury Consultation: RRP for Financial Market Infrastructures

On 1 August 2012, HM Treasury published a consultation document entitled "Financial sector resolution: broadening the regime". Citing the collapses of Bear Stearns (an investment firm) and AIG (an insurer), the UK Government is reviewing the need to establish a resolution regime framework for non-banks on a more accelerated timetable than that currently envisaged in ongoing international work. The HM Treasury recently published a summary of responses to the consultation on Non-bank resolution - see recent blog post on this summary.

The consultation was open for responses until 24 September 2012. A summary of the responses to the consultation document was also published on 17 October 2012, and a blogpost on this topic dated 25 October 2012 can be found at www.recoveryandresolutionplans.wordpress.com. It asked for views on the most appropriate type of policy response with respect to systemically important firms, specifically whether existing administration/ run-off arrangements should be extended/strengthened or whether a new comprehensive resolution regime should be introduced. The consultation paper addresses four broad sectors:

- investment firms and parent undertakings;
- central counterparties (CCPs);
- non-CCP financial market infrastructures (non-CCP FMIs); and
- insurers.

HM Treasury considers that each of the above categories may be systemically important. In addition, it does not preclude the possibility that other types of non-bank financial institution may also be systemically important, specifically referring to hedge funds. However, it accepts that the case against insurers in "less clear cut" and recognises that, in practice, it is likely that only some, if any, of each type of entity within a category will actually be systemically important.

The UK Government expects the benefit of taking action pursuant to a formal resolution regime to exceed the costs of disorderly failure. As such, it believes that there is a strong case for introducing powers earlier than is expected as part of any European process. However, it does not propose to introduce stabilisation powers for insurers, non-CCP financial market infrastructure or shadow banking entities at this stage. A more detailed summary of the consultation paper is provided in the schedule to this article.

Schedule

1. Investment Firms

The consultation paper notes that the UK Special Administration Regime ("SAR") introduced under the Banking Act 2009 has strengthened the UK's ability to manage the failure of investment firms. However, due to the fact that the resolution powers established under the Banking Act 2009 only apply to deposit-taking institutions, it believes that there is no suitable regime for managing the failure of:

- systemically important investment firms;
- parent undertaking(s) of systemically important investment firms; or
- parent undertaking(s) of deposit-taking institutions.

As such, the UK Government intends to legislation in order to plug this gap.

1.1 Investment firms that would be subject to the new resolution regime

The UK Government believes that it would be inappropriate to apply a prescriptive definition of 'systemic investment firm' due to the fact that:

- some factors which will be relevant in assessing systemic importance will inevitably change over time; and
- too restrictive a definition may make it difficult to take action to resolve a non-systemic firm before it actually reaches the point of failure.

As such, all UK incorporate investment firms will be subject to the new resolution regime. For these purposes, an 'investment firm' means a UK institution which is an investment firm for the purposes of the Capital Adequacy Directive.[1] However, it is important to note that the proposed stabilisation powers would only be exercisable with respect to a systemic investment firm. Nonsystemic firms would be entered into the existing SAR.

1.2 The application of the new resolution regime to parent undertakings

Certain restrictions will apply to the use of stabilisation powers with respect to parent undertakings:

- the intended legislation will only provide resolution powers for UK firms and parent undertakings;
- the proposed stabilisation powers will only be exercisable in relation to financial elements of the holding company; and
- where there is an overall parent holding company which owns both financial and non-financial subsidiaries and an intermediate holding company which owns the systemic financial subsidiary, stabilisation powers will only be exercised at the intermediary level.

[1] Directive 2006/49/EC

1.3 Trigger conditions for intervention

Intervention will only be possible with respect to a systemically important firm, and will require the relevant firm's regulator to be satisfied that the firm is failing, or likely to fail, its regulatory threshold conditions and that it is not likely that action (other than resolution action) will be taken to enable the firm to meet its threshold conditions.

1.4 Objectives for the resolution of investment firms and parent undertakings

The objectives for resolution of a systemically important investment firm and its parent undertakings will largely mirror the objectives for resolution of a deposit-taking institution, but will include the following additional objectives:

- protection of client funds and client assets; and
- avoiding unnecessary interference with the operations of financial market infrastructure.

1.5 Design of stabilisation powers

The powers to resolve a systemically important investment firm and/or its parent will be broadly similar to those contemplated in the draft Recovery and Resolution Directive (the "RRD") i.e. transfer to a third party purchaser or a bridge institution. However, the following powers will not be implemented separately from the RRD process:

- bail-in;
- transfer to an asset management vehicle; and
- a stay on the exercise of early termination and close-out netting rights in financial contracts held by counterparties of a failed firm.

1.6 Safeguards

Safeguards to protect property rights affected as a result of the exercise of property transfer powers will be established by secondary legislation.

2. Central counterparties

2.1 Scope of the intended resolution regime

The Government's proposed resolution regime for CCPs would capture any clearing house incorporated in the UK and recognised under Part 18 of FSMA 2000. However, only systemically important CCPs would be subject to the resolution powers. Before being able to exercise a stabilisation power to resolve a failing clearing house, the Bank of England would have to be satisfied that the exercise of stabilisation powers is necessary in pursuance of specified public interest aims. The powers would be similar to the stabilisation powers proposed for investment firms albeit that it is not envisaged that HM Treasury would have the power to transfer a clearing house into public ownership.

2.2 Trigger conditions for intervention

Conditions for intervention in order to ensure the continuity of clearing services would be triggered where a clearing house had breached, or is likely to breach, the conditions which the clearing house must meet in order to be, and continue to be, a recognised clearing house. Two further preconditions to intervention would be that:

- it is not likely that other actions would enable the clearing house to once again meet its authorisation conditions; or
- notwithstanding that other actions would restore the clearing house to compliance with its authorisation conditions, such actions would undermine the continuity of clearing services.

2.3 Resolution Powers over CCPs

2.3.1 Power to direct clearing houses

The Bank of England would have the power to direct the actions of a clearing house if it was satisfied that this is in the public interest with respect to:

- protecting, or maintaining confidence in, the UK financial system; or
- protecting or maintaining the continuity of the services provided by the CCP or the CCP itself.

This power would enable the regulator to direct a CCP to take, or refrain from taking, action to address risks to its solvency or any other matter. Specifically, a CCP could be required to amend/activate its rules or introduce emergency rules.

2.3.1 Power of Direction over an Administrator

The resolution authority would have power to direct the administrator of a failed CCP (subject to certain conditions) to take action to address risks to financial stability and ensure the continuity of services in support of an acquirer of the CCP's business.

2.4 Objectives for operation of a resolution regime for CCPs

The objectives of the authorities with respect to the resolution of clearing houses would closely follow those already applicable to deposit-taking institutions under the Banking Act 2009 but would include an additional objective reflecting the need to maintain the continuity of the provision of critical central counterparty clearing services. As such, the set of resolution objectives would be as follows:

- to maintain the stability of the financial systems of the United Kingdom;
- to protect and enhance public confidence in the stability of the financial systems of the United Kingdom;
- to maintain the continuity of the provision of central counterparty clearing services;
- to protect public funds; and
- to avoid interfering with property rights in contravention of the Human Rights Act 1998.

2.5 Stabilisation powers for CCPs

The stabilisation powers applicable to CCPs would broadly follow the design of existing stabilisation powers for banks, namely enabling the transfer of securities, property, rights and liabilities to a private sector purchaser or a 'bridge' CCP. In order to ensure that clearing services remain uninterrupted, the Bank of England would also have power to:

- temporarily suspend termination rights and ensure that any application of the stabilisation powers did not constitute an event of default with respect to any of the CCP's contracts;
- transfer membership agreements and clearing member positions and transfer and/or amend the rules of operation of a failed clearing house for a specified period of time or until a specified event occurred;
- direct the actions of any insolvency practitioner appointed in relation to a clearing house; and
- impose liabilities on shareholders and/or members of a CCP (potentially subject to a liability cap), to require them to contribute funds to restore a clearing house to viability.

2.6 Safeguards

Safeguards will include:

- requirements that creditors are not discriminated against on grounds of nationality;
- compensation arrangements for those affected by the exercise of stabilisation powers; and
- measures to protect against partial property transfers.

3. Non-CCP financial market Infrastructures

3.1 Improving the regulatory framework for managing the failure of non-CCP FMIs

Non-CCP FMIs include:

- central securities depositories and securities settlement systems;
- payment systems;
- exchanges and trading platforms; and
- trade repositories.

There is currently no resolution regime for non-CCP FMIs, which are subject to ordinary UK insolvency law. However, the failure of a non-CCP FMI would likely result in the cessation of critical services. As such, the UK Government believes there is a need to legislate in this area and identifies two broad approaches:

- strengthening the existing insolvency arrangements to ensure that the available insolvency mechanisms are adequate; and
- developing a new, comprehensive resolution framework.

The trigger for intervention seems likely to occur when a firm is failing, or likely to fail, to continue to meet its regulatory recognition/authorisation/operational requirements, with no reasonable prospect of remedial action to address this.

Under the first approach, a modified administration regime is contemplated under which an administrator would have the specific objective of ensuring the continuity of services, supplemented by additional powers to enforce a stay on early termination rights and a moratorium on payments to creditors.

Under the second approach, a new resolution regime would be put in place, supplemented by appropriate powers such as:

- the power to transfer some or all of a non-CCP FMI's operations to a third party provider or to a bridge institution;
- loss allocation or cash-call powers under which the system's owners or members/users could be required to bear losses and/or provide additional funding; and
- step-in powers under which the authorities could take over the management of the FMI, irrespective of any insolvency proceedings.

4. Insurers

4.1 Improving the regulatory framework for managing the failure of insurers

The UK Government broadly accepts that disruption to core insurance activities in themselves is unlikely to cause financial instability. However, it is of the opinion that insurance institutions can still have a degree of systemic potential depending on:

- the complexity of business models, particularly interconnectedness with banks;
- dependencies and inter-linkages with other financial institutions (including through undertaking non-traditional insurance activities);
- institution size; and
- market share in insurance products that are necessary, or compulsory, for the functioning of economic activity.

As such, the Government wants to ensure that, on the failure of any insurer:

- an orderly market exist can be facilitated; and
- an appropriate degree of policyholder protection should be achieved, including, where appropriate, though continuity of cover.

The UK does not have a specific resolution regime for insurers. Presently, failed insurance firms are dealt with through 'run off'. However, this process can result in the effective subordination of longer-dated policyholders. With the goal of ensuring the continuity of payments and protection for policyholders, particularly (though not exclusively) long-term policyholders, the consultation paper identifies two possible options for managing the failure of insurance firms:

- reviewing the adequacy of existing insolvency arrangements; and
- assessing whether evidence exists to justify the establishment of a comprehensive set of resolution stabilisation tools specifically for the insurance industry, including the power to transfer assets and liabilities from a failing insurer to a third party.

Identifying 'non-standard terms' in Derivative Documentation

Currently financial institutions tend to focus on general principles to help with the identification of "non-standard terms" in derivatives documentation despite a lack of clarity on the topic.

Feedback Statement 12/1 (FS 12/1), published by the FSA in May 2012, provides detailed guidance to firms which are subject to the UK's recovery and resolution planning rules. In general, FS 12/1 is a superb roadmap document, assisting firms through the detailed data requirements which form the core of recovery and resolution planning. Unfortunately, there remain a number of areas of FS 12/1 in which clarity is lacking. One such area appears in the context of Module 3.7 ("Derivatives/ Securities Financing"), which forms part of the 'Group structure & key legal entity information' section.

Module 3.7

Module 3.7 requires firms to provide information with respect to their derivatives exposures. Exposures are to be split into three broad categories, being:

- Exchange traded derivatives;
- OTC but centrally cleared derivatives; and
- OTC bilateral derivatives.

Within each category, detailed reporting is required in four main areas:

- Counterparty details;
- Exposure data;
- Collateral data; and
- Documentation.

Within the "Documentation" section, firms must provide, inter alia, information regarding "non-standard terms". Rather unhelpfully, the summary provided by the FSA to explain the background to the data requirement states simply that its purpose is to "determine requirements regarding trade termination etc". However, on the plus side, two examples of a "non-standard term" are provided, being:

- Events of default, and
- Cross-default clauses.

No other information is provided to assist firms with their submissions. Additional FSA guidance was expected on 13 August 2012, but this seems unlikely to address this particular issue. Consequently, many firms, particularly those with large portfolios of derivative documentation, have been left struggling to understand where to draw the line.

Unfortunately, there is no single correct answer to this question. None-the-less, it would seem possible to identify two general principles which will assist with the identification of "non-standard terms" in derivative documentation.

We would suggest that these principles are that:

- An objective, rather than a subjective, measure of what is "non-standard" is appropriate; and
- Clauses should only be regarded as "non-standard" to the extent that they could:
  - Have an adverse effect on the application of a resolution tool; or
  - Constitute a barrier to resolution.

An objective measure of what is "non-standard"

ISDA negotiation practices have converged significantly over recent years on a number of issues with the result that it is possible to discern a number of 'industry standard' positions. As such, the ISDA negotiation policy of a firm will often represent a good starting place to assist in understanding what can be regarded as 'standard'. Clauses in executed documentation which lie outside of an agreed negotiation policy should raise internal flags and merit further investigation. Inevitably, however, this exercise is of limited assistance as it represents a firm's subjective view of its own risk tolerance. Despite the fact that recovery and resolution planning remains a very firm-specific exercise, if assessments of resolvability and the contents of resolution plans are to be meaningful and consistent across EU Member States, a truly objective benchmark is required. An assessment of the effect of a contractual clause on the ultimate resolvability of a firm creates this objective standard.

"Non-standard" clauses must affect resolvability

The power to transfer, modify or cancel contractual arrangements entered into by a firm under resolution form the essence of the Resolution Powers conferred on resolution authorities pursuant to the draft RRP Directive. Accordingly, in assessing whether a contractual provision could have an adverse effect on the resolvability of a firm or the application of a resolution tool, one should be primarily concerned with the ability of a resolution authority to transfer or terminate a derivatives transaction so as to help facilitate an orderly wind-down of the firm in question.

Towards defining a set of "non-standard" terms

With this in mind, it is possible to group contractual provisions into three main categories:

- Probable Non-Standard Terms;
- Possible Non-Standard Terms; and
- Unlikely to be Non-Standard Terms.

The Schedule to this article applies the principals set out above to a number of clauses of the type typically found in derivatives documentation in order to generate the groupings referred to above. However, it is important to recognise that, whilst an assessment of the effect of a contractual provision on the resolvability of a firm helps to create an objective benchmark regarding what is "standard", the exact positioning of this benchmark will inevitably change over time. What could be regarded as a "standard" provision, say, 5 years ago may well not be standard today. Similarly, what is standard today may not be standard in another 5 years time. As such, this aspect of recovery and resolution planning must be kept under periodic review.

Group 1: Probable Non-Standard Terms

Clause	Explanation
Events of Default	Specifically referred to in FS 12/1
Cross-default/Crossacceleration	Specifically referred to in FS 12/1
Termination Rights Generally	Termination rights should be regarded in the same light as Events of Default
Ratings Downgrade Clause	Often takes the form of an Event of Default/ Additional Termination Event
Material Adverse Change Clause	Often takes the form of an Event of Default/ Additional Termination Event
Credit Event Upon Merger linked to specific ratings or other factors	CEUM is a Termination Event under a standard ISDA Master Agreement
Unusual Governing Law	Effective application of resolution tools may be more difficult/impossible in certain jurisdictions which do not recognise the powers of resolution authorities

Group 2: Possible Non-Standard Terms

Clause	Explanation
Undisclosed Agency Arrangements	May make application of the resolution tools more difficult as the identity of the counterparty may be difficult to ascertain
Indemnities	Should not of itself prevent exercise of a resolution tool but may still constitute a barrier to resolution if indemnities are enforced
Illiquid CSA Collateral	Should not of itself prevent exercise of a resolution tool but may still constitute a barrier to resolution in terms of transferring or terminating transactions
ISDA First Method	Should not of itself prevent exercise of a resolution tool but may still constitute a barrier to resolution if a counterparty has a right to 'walk away' without making payment
Ratings Dependent CSA Credit Support Amounts	Should not of itself prevent exercise of a resolution tool but may still constitute a barrier to resolution if additional collateral must be posted
Unusually wide definition of "Specified Entities"	Widens the application of ISDA Events of Default and/or Termination Events

Group 3: Unlikely to be Non-Standard Terms

Clause	Explanation
Automatic Early Termination	AET is primarily designed to protect against 'cherry picking'. However, in certain circumstances the automatic termination of trades could constitute a barrier to resolution. Nonetheless, it is placed in Group 3 due to the fact that, under normal circumstances, resolution tools would have been implemented before insolvency (and therefore AET) occurs
Non-daily CSA calls	Should not be effective to prevent the exercise of the resolution tools
Non-zero/large CSA Thresholds/MTAs	Should not be effective to prevent the exercise of the resolution tools
Unusually large/small collateral haircuts	Should not be effective to prevent the exercise of the resolution tools
Non-assignment Provisions	Should not be effective to prevent the exercise of the resolution tools

The Cost of (and of not) Implementing a Living Will

Although the cost of of implementing a Living Will is significant, the cost of not implementing a recovery and resolution plan may outweigh any minor cost savings from doing the minimum.

The Cost of Implementing a Recovery and Resolution Plan

By any measure, the costs of properly implementing an RRP are significant. Using the FSA's own cost-benefit analysis conducted as part of Consultation Paper CP11/16, the costs to firms of preparing and maintaining a Recovery and Resolution Plan (excluding the costs associated with CASS Resolution Packs) over the next five years can be estimated as:

Category of Firm	Cost (GBP Million)
High Impact	56,490,833
Medium High Impact	8,522,417
Medium Low and Low Impact	3,299,333

These figures seem to be supported by anecdotal evidence. Bob Diamond, former CEO of Barclays testified before the Treasury Select Committee on 8 June 2011 that Barclays had, at that point, spent over GBP 30 million on the production of its recovery and resolution plan. More recently, a survey conducted by Ernst & Young concluded that UK firms estimated spending USD 20 million on average on the production of a recovery and resolution plan – a figure which did not include any additional costs incurred in overcoming barriers to resolution, such as changes to legal structure, funding arrangements or operational processes. Moreover, the same survey suggested that the process requires a material investment in terms of headcount, involving on average 10 full time members of staff dedicated to the project and a further 40-50 employees involved to a lesser degree in the collation of the information required to underpin a plan.

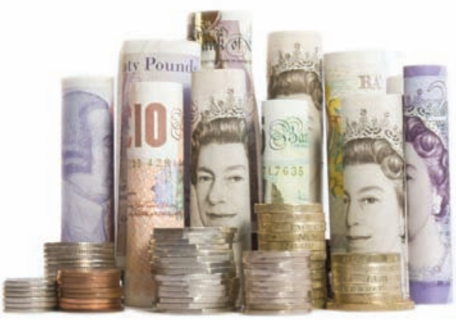
In these circumstances, it is perhaps not surprising that some firms view the process of recovery and resolution planning as little more than a necessary evil. This seems to be particularly the case with respect to resolution planning in which a firm is effectively asked to contemplate its own demise and accordingly draft its own funeral plan – a state of mind which can be seen as synonymous with managing for failure rather than success.

The Cost of Not Implementing a Recovery and Resolution Plan

Risk Weighted Asset Benefits

Once enacted, Basel III will require systemically important banks to have equity of at least 10% of risk-weighted assets (RWAs) plus credibly loss-absorbing debt. However, some jurisdictions have gone further in "gold-plating" (or applying a "Swiss finish") to regulatory capital requirements on their local banks.

The UK appears to be one such jurisdiction. In September 2011, the Independent Commission on Banking (ICB) issued its final report, the conclusions of which were accepted in full by the UK government in December of that year and are now the subject of draft legislation. The ICB has recommended that the retail and other activities of large UK banking groups should both have primary loss-absorbing capacity (i.e. regulatory capital and bail-in bonds) of at least 17%-20% of RWAs.



Within the 17%-20% range detailed above the ICB recommends applying regulatory discretion about the amount and type of loss-absorbing capacity.

In particular, the ICB has suggested that 3% extra equity capital might be required of a UK banking group that was judged "insufficiently resolvable to remove all risk to the public finances". In contrast, no additional equity capital might be needed for a bank with "strongly credible recovery and resolution plans".

It would be simplistic to assume that the ICB's recommendations would be applied in a binary fashion by the FSA, or its successor, the Prudential Regulation Authority (i.e. a 3% RWA penalty or no penalty at all with nothing in between). Nonetheless, it is instructive to attempt to place an actual value on this 3% figure. The table on the next page is based on the 2010 financial statements of a number of major UK banks and building societies, and quantifies the annual amount of interest (assuming a rate of 50 basis points) that would be payable if an amount equal to 3% of RWA, being freed up as a result of having a robust recovery and resolution plan, were simply placed on overnight deposit.

The potential dangers of false economy become clear – the opportunity cost of not implementing a robust recovery and resolution planning regime may quickly outweigh the marginal cost savings derived by doing just enough, but not more, to comply with RRP regulations.

Bank	Risk-Weighted Assets (GBP Million)[1]	3% of Risk Weighted Assets (GBP Million)	Annual Interest (GBP Million)[2]
Barclays PLC	398,000	11,940	59.7
Clydesdale Bank PLC	28,700	861	4.31
HSBC Bank PLC	201,700	6,050	30.26
Lloyds Banking Group	406,400	12,190	60.96
Nationwide Building Society	50,100	1,500	7.52
Northern Rock PLC (now Virgin Money)	3,620	110	0.54
Principality Building Society	2,760	80	0.41
Royal Bank of Scotland PLC	409,700	12,290	61.46
Santander UK PLC	73,560	2,210	11.03
Standard Chartered Bank PLC	155,150	4,650	23.27
Yorkshire Building Society	11,200	340	1.68

[1] Where financial statements are reported in USD, the USD/GBP exchange rate as at 8 March 2012 has been used for comparison purposes.
[2] Assuming an overnight interest rate of 0.5%

Business Benefits

The process of creating and maintaining a recovery and resolution plan entails a large-scale data extraction exercise the purpose of which is to understand group-wide exposures, interdependencies and other areas of weakness. As a result of acquiring and assimilating this information areas where there is room for improvement quickly become apparent. More specifically, some of the benefits of implementing a robust recovery and resolution planning regime include:

- Gaining a better operational understanding of the overall business;
- Facilitating the streamlining of group structures;
- Optimisation of group funding and liquidity; and
- Understanding intra-group dependencies.

Regulatory Risks

The FSA has a range of options it can apply in the event of non-compliance with the regulations regarding recovery and resolution plans. However, the two which seem most likely to be used in this context are:

- The appointment of a “skilled person” pursuant to section 166 of the Financial Services and Markets Act 2000 to gather the required data or perform the required acts – the risk then becomes one that the recovery and resolution process is removed from the control of the firm; or
- The ultimate sanction under section 45 of the Financial Services and Markets Act 2000 pursuant to which the FSA has the power to vary, or even cancel, a firm’s permission to carry on a regulated activity.

Reputational Risk

In light of the continuing round of ‘banker bashing’ amongst politicians and the press, firms would be well advised to grasp the recovery and resolution planning regime as an opportunity to present themselves as responsible corporate citizens. In particular, given the recent scandal over client money held with MF Global, a concerted effort to comply, and be seen to comply, with the requirements of the CASS Resolution Pack rules would appear to be sensible.

Conclusion

Recovery and resolution planning is the product of a political agenda which has its roots in the financial crisis of 2007-2008. The quasi-public nature of the service provided by banks to the real economy, coupled with the overriding desire within government to ensure that public funds never again bail out a financial institution, means that RRP is here to stay. By design, it is a task that is both large in scale and intellectually challenging in scope. Moreover, it is at least arguable that, in order to be compliant with existing regulations, a plan must be in a constant state of updating - a possibility which implies a huge administrative burden on firms.

Ironically, the less a firm invests in its recovery and resolution planning process, the more concerned the FSA will be about that firm and the greater the degree of supervision to which that firm will become subject. In turn, this is likely to result in more frequent regulator requests for plan updates with the ultimate result that the overall cost of plan maintenance will increase. As such – even where motivated primarily by a desire to save cost - firms would be well advised to focus from the outset on the material benefits to be derived from the implementation of a strategic, robust and long-term solution to the question of recovery and resolution planning.