

## Living wills – the new regulatory regime for financial institutions

---

### FAQs about the new requirements -

- To manage for the firm's own failure, for example, through the preparation and operation of Recovery and Resolution Plans (living wills or "RRPs") supervised by internal Business Resolution Officers
- To satisfy the authorities of an acceptable outcome if the firm were allowed to fail without any state funded rescue; or to restructure or refinance to achieve this

### Recent Developments

During 2009, the FSA and the UK government pressed ahead with the development of a new regime for RRP. This was seen as a key response to the financial crisis and the failures of the regulatory system evident both in the need for bank rescues in the retail sector and the consequences of the Lehman's failure in investment banking. The UK pressed ahead despite the lack of international consensus and many unresolved issues on international coordination and cooperation. Since 2009, the timescale for the introduction of the new UK regime has slipped. The new legislative powers were included in the Financial Services Act 2010 (enacted shortly before the General Election campaign) and the outgoing Labour Government announced that, if re-elected, it would concentrate on achieving international consensus (including at the FSB level) by the end of 2010 before implementing the new UK requirements. The Conservative party and the Bank of England support the living wills concept, so we expect the new RRP powers to be implemented whatever the outcome of the general election of 6<sup>th</sup> May.

There are a number of related reforms, being developed in parallel with the living wills regimes including;

- Reform of the client asset regime – the protection of the 'trust estate' will eventually form a key element in living wills
- The focus on legal entities and management, structuring and supervision directed at the survivability of individual companies within a group – particularly international groups

### Scope - which institutions will be subject to the new requirements?

No final decision has been made but current plans include firms in the table below .

Other firms are likely to be drawn into the new regime as it develops - exchanges, CCPs, MTFs and even some funds. Eventually, there are likely to be indirect impacts on some intermediaries. We expect some obligations to be applied more broadly than others and there may be a proportionate approach in some areas to make applicable requirements less onerous for smaller firms.

Type of firm	Scope of application
Banks and building societies	All firms (regardless of size) which would cover all institutions within the scope of the <i>SRR</i> regime. This includes retail, commercial and investment banks
Non-bank investment firms	All MiFID investment firms (regardless of size).
General insurers and reinsurers	Likely to apply at least to larger firms
Life offices	Likely to apply at least to larger firms

The general direction of travel is clear –

- Failure planning will be an important new part of the regulatory regime
- Firms will need to be able to ‘dry-run’ their failure and demonstrate an acceptable outcome without the risk that public funds might have to be deployed
- There will be a new focus on the position of separate legal entities within a group – to be enforced by FSA and the new BROs
- There will be broad ongoing requirements to maintain the RRP’s and going concern business decision-making will have to consider the impacts on the resolution plan.
- The regime will be enforced by the increasing number of internal “policeman” – a BRO for resolution and a client asset officer.

## What are the new UK requirements?

There are currently two sets of proposals –

- Under the Financial Services Act 2010, the FSMA has been amended to require FSA to make rules (under its existing powers) to require authorised firms to prepare and maintain *RRPs*. FSA will consult on the scope of application and the details of the *RRP* regime later this year. HMT can dictate the scope but this must include all UK deposit-taking firms as a minimum.
- The investment firm regime is currently the subject of a consultation by HMT. This contains a large number of new requirements to address the problems highlighted by the Lehman Brothers’ administration. These include detail on the investment banking component for ‘investment firm resolution plans’ under the RRP regime.

## What are the international rules?

Internationally, the FSB has compiled a list of about 25 banks and broker-dealers and six insurance groups<sup>1</sup> that have been “earmarked” for the new cross-border supervision exercise which will include international co-ordination of *RRPs*. The international regime for RRP’s is still being developed (e.g. via the FSB); it is not yet clear how RRP’s will operate at a EU level and whether there will be EU legislation to harmonise requirements<sup>2</sup>. The issues are complex; under the existing EU directive the home state procedure and insolvency law applies, so member states tend to use home state powers to ring-fence national assets of a legal entity within a banking group. A regime that planned and implemented resolution on group-wide/pan-European basis – for example at bank holding company level - would only be possible if member states could agree in advance a basis as to how losses would be shared (the recurring conundrum of ‘burden sharing’).

“..a first-order difference between...countries whose regime effectively permits a de facto ring-fencing of locally domiciled assets for local depositors and .. those that treat liquidation as a joined up, global exercise...”

Bank of England 16/11/09

<sup>1</sup> The list includes six insurance companies – Axa, Aegon, Allianz, Aviva, Zurich and Swiss Re – which sit alongside 24 banks from the UK, continental Europe, North America and Japan.

<sup>2</sup> The EU has completed a very high-level consultation on cross-border crisis management; for 2010 it is planning a public hearing and a roadmap report covering resolution (and early intervention and insolvency law).

### Discussion point –

- RRP's have to focus on the separate position/resolution of each legal entity.
- How will RRP's be co-ordinated across companies with cross border branches within an international group?

The UK has been leading the debate and will influence both the EU and global consensus on living wills. Quite what the level of consensus and cooperation can be achieved at EU and FSB level remains to be seen. Groups would face the task of looking at each resolution entity by entity – assessing each entity under the applicable national regime(s). This would involve looking at branches including the position of EU branches under the existing directive. In addition, individual entities would be members of different national deposit protection arrangements (unless and until international schemes are put in place – such as the mooted single scheme for the EU). In the absence of international agreement, institutions would have to wrestle with the inherent conflicts (and turf wars) (i) at an entity level, between home and host state authorities, (ii) at a group level, between the group supervisor and subsidiary supervisors and (iii) further conflicts at subgroup levels. The existing mechanics for dealing with these issues under the current

'going concern' regulation are not (yet) duplicated in the RRP regime, or, more importantly, in the resolution and insolvency regimes themselves. National authorities will tend to be concerned about local depositors; holding company/home state authorities will be concerned about the liabilities of branches and subsidiaries abroad – whilst host states will be concerned about a lack of control and the survivability/ring fencing of local operations/assets.

## What is a Recovery Plan (*RCP*) and what are the applicable requirements?

A *RCP* is a contingency plan setting out how the institution would react in times of stress to avoid failure (and *resolution*) and continue as a going concern. A *RCP* must (under current FSA proposals) contain:

“Can I recover from these stressed scenarios with my current business model?”

Bank of England 17/11/09

- A capital recovery plan (including contingent capital and other capital facilities/insurance);
- A liquidity recovery plan (including access to contingent liquidity insurance/facilities and emergency provision of central bank liquidity);
- Options to facilitate *recovery* (such as exiting particular lines of business, selling subsidiaries or raising fresh capital);
- Processes allowing the firm to reduce the risks it is exposed to in the event of experiencing severe stress (“de-risking”);
- An assessment of the possible impact of the firm’s failure on the wider industry or sector and mechanisms allowing it to prevent or limit that impact (“contagion control”); and
- A process for deciding upon and executing the *RCP*, the circumstances in which it would be appropriate, the key dependencies, the information that would be required by the firm or third parties (and the ability to provide that information in the time available), and the legal, financial and operational constraints on taking the proposed action.

## What is a Resolution Plan (*RSP*) and what are the applicable requirements?

A *RSP* involves a contingency plan looking at the ways in which resolution could be achieved if the institution were to ‘fail’, for example if it became clear that the *RCP* was unlikely to save the firm. A *RSP* must (under current FSA proposals) contain:

“Resolution plans must be produced and owned by the authorities ... but firms have a vital role ...”

Bank of England 17/11/09

- In the case of deposit-taking firms, an explanation of how the *SRR* will apply to them in the event of failure;
- In the case of deposit-taking firms, a detailed assessment of the potential obstacles or impediments (financial, legal, operational) to the *resolution authorities* using the bank insolvency procedure, a partial transfer of assets and liabilities (either to a bridge bank or private sector purchaser), a whole bank transfer of the assets and liabilities, the taking into temporary public ownership of the deposit-taker, or the taking into temporary public ownership of any holding companies that sit above the deposit-taker;

“With this structure and business model, could I [the resolution authority] achieve a resolution at acceptable cost?”

Bank of England 17/11/09

- In the case of firms that do not fall within the *SRR*, an explanation of how regular insolvency rules will apply to them, and of how potential barriers to implementation of the *SRR* have been identified and removed;
- In the case of systemically important firms, a description of how the *resolution authority* can access relevant data to assess the available *resolution* options (e.g. by consulting relevant documents in a secure data room);
- Mechanisms allowing the firm to minimise damage to other participants in the system by detaching itself from its surrounding infrastructure, such as its relevant payments, clearing and settlement infrastructure (“unplugging”); and
- An illustration of the relationship between the different entities in the firm’s group, in each case explaining the regulatory status of group entities, the basis of their relationship (e.g. legal status, financial, staffing, premises) and contingency arrangements in case of interruption to that relationship.

“If CoCos could form a material part of recovery plans, the landscape might just be transformed”

Bank of England 16/11/09

## What are investment firm resolution plans and which firms are impacted?

These requirements will apply (under current HMT proposals) to non-bank investment firms and to banks conducting investment business. Firms handling client money or assets will be caught; some requirements are likely to apply to all such firms but non-bank investment firms might only be required to have formal resolution plans if they are judged to be systemically important. FSA will consult on both the scope and the detail of the requirements.

HMT is consulting on the investment business content of resolution plans. These will focus on two stages before the formal administration commences – phase 1 for internal actions and phase 2, a ‘pre-insolvency corridor’, for market-facing action.

## What other resolution requirements will apply to investment business?

Requirements -

- To appoint an internal ‘business resolution officer’ (BRO) with responsibility for ensuring board level action/compliance in relation to resolution requirements. This will be an FSA approved person and form part of the broader corporate governance arrangements. The BRO will have extensive responsibilities both during ‘business as usual’ operations and at times of distress –
  - As the point of contact for FSA on failure management/resolution
  - To ensure that the requirements in relation to resolution plans and the items below are met on a continuous basis. It is suggested that the BRO will effectively be a policeman responsible for ensuring that management decisions take full account of resolution at a legal entity level.
- To maintain business information packs (BIPs) for use by regulators and administrators when the firm fails. These will be an enhanced regulatory business plan with an additional focus on use by administrators not familiar with the firms business or jargon. The key emphasis is on the position of the individual legal entity concerned rather than the group as whole; this requires legal entity financial reporting and legal analysis of group relationships; the question of operational independence also arises. BIPs will require continuous updating, regular auditing, stress testing/approval and may be held in virtual data rooms; they will cover –
  - Business structure
  - Business information and risk management
  - Business strategy and decision making
  - Personnel
  - Key operational costs and logistics
  - Funding and liquidity
- Contractual provisions to ensure continuity of service (during resolution) from key staff and suppliers. This will include requirements relating to employment contracts with key staff to ensure they remain in employment and are

incentivised to assist the administrator for at least 90 days. Contracts with suppliers will have to be insolvency proof for at least 90 days; this will cover a wide range of infrastructure and service providers. There will be requirements for group company suppliers, which will also cover their insolvency. There may be significant international issues to resolve. Mandatory on-shoring is not currently considered viable from a commercial perspective but a requirement for the on-shoring of critical data is being pursued.

- A ring-fenced operational reserve to pay for key staff after a failure.

## Will the RRP process be used to impose fundamental change on an institution?

Yes, the authorities clearly intend to use the RRP approval process to impose fundamental change on some institutions.

The RRP process is likely to be used as the mechanism to gauge and remedy many topical concerns such as 'too big to fail' and 'narrow banking' – the separation of retail deposit taking from so-called casino investment banking. These issues may be addressed in some countries by restrictions on size and by limitations on crossover or ring fencing – as proposed in the US under the Volcker rules. (Insurers have long been restricted to insurance business). In the absence of hard industry wide limits of this kind, the risk to depositors may be assessed for each bank individually through the RRP process, with the onus on the bank to show, for example, how depositors are protected from risks arising in proprietary trading operations. Even in countries without the Volcker rules, large universal banks may still have to be quite imaginative, in terms of protection and structuring, to satisfy the authorities on this count.

“...key objectives for resolution plans... a means to deal with the 'too complex to resolve' state by demonstrating where structures need to be changed...”

Bank of England 17/11/09

The *resolution authorities* will need to be satisfied that at any time they could trigger *resolution* and implement the *RSP* without putting taxpayer money at (unacceptable) risk and with confidence that the resulting losses and disruption, although undesirable, would be acceptable.

It seems there are different tests reflecting different objectives within the resolution and regulatory legislation. At one level, the concern is about financial stability with a focus on systemically important firms, but, at another level, there is also a focus on consumer protection objectives and the aims of the SRR to avoid loss of (protected) deposits from the failure at any bank or building society (however small).

“...I see RRP as a device to enable tough questioning of structures and business models.....”

Bank of England 17/11/09

This may depend on whether the institution is sufficiently small (for example to be insured within the capacity of a deposit insurance guarantee scheme or to be protected by a resolution fund such as those established in Spain and Sweden) and its structure sufficiently simple (to enable effective *recovery* and *resolution* planning and supervision); it may also be necessary to establish that the financial system and other participants are not overly dependant on the institution concerned.

The *FS Act* amends the *FSMA* to give *FSA* an additional statutory objective to enhance the stability of the UK financial system. *FSA* will therefore have broad powers in setting out the criteria that must be met for *RRPs* to be regarded as satisfactory (and the detailed content of *RRPs*). *FSA* is given an express power to require a draft *RRP* to be revised and this could be used to specify remedial steps of the kind considered above (although it may be argued that this power should have a clearer basis).

## Gauging the impact of failure – systemically significant?

Assessing the impact of a firm's failure under an *RSP* is difficult particularly as the impact may be dependant, to a significant extent, on market circumstances at the time. The failure may be well within the capacity of deposit protection if it is an isolated event; but in a downturn, as we have seen, there may be “herd effect” when many banks are vulnerable and the failure of even a small firm may trigger, or be triggered by, a broader run well beyond the capacity of the scheme. There are huge unresolved issues about the system itself and it will be difficult to test the impact of resolution without knowing, for example, what the capacity of deposit protection (and other *FSCS* type insurance) will be. A move to an insurance model - pre-funded by risk-based premia – seems inevitable. Indeed the *RRP* process might well be used for the risk rating of the institution for deposit protection or resolution fund purposes (including the bank's *DLGD*). Eventually, a more structured *CoLR* regime may emerge for systemically significant firms.

Discussion point –

- Data on-shoring?
- Will suppliers accept insolvency proof contracts/terms?

## How will *RRPs* be used and maintained?

The objective of *RRPs* is to ensure that firms possess contingency plans allowing them to adapt to stress and that they remain in a permanent state of readiness for *resolution*. Drawing up an *RCP* and an *RSP* will not, in and of itself, allow a firm to achieve this objective if the firm's structure, operations or exposures could jeopardise a prompt *recovery* or orderly *resolution*. In particular, an orderly resolution may require a fast transfer of protected consumers. For this reason, the preparation of *RRPs* may need to coincide with a restructuring of the firm's reporting lines, business divisions, contractual obligations, liabilities or group entity structure.

Furthermore, to be capable of orderly *resolution* under the *SRR*, deposit-taking firms will need to ensure prior compliance with the Single-Customer View (*SCV*). The *SCV* is an FSA requirement that the IT systems of banks provide a complete view of any customer's balances across the bank's different products and brands, rendering each customer's compensation entitlement apparent. In the event that a firm's retail accounts are transferred to another institution, systems must be *SCV*-compliant in order to enable payout of compensation within a target of 7 days of the firm's default.

*SCV* requirements exist independently of the *SRR* and the framework for *RRPs*. Deposit-takers subject to *SCV* requirements will need to submit a pre-implementation report to FSA by 31 July 2010, and implement *SCV* systems by 31 December 2010.

### Discussion point –

- What will be the role of in-house counsel?
- What will be the role of external counsel?
- What legal opinions/sign-off is likely to be required by the board, the BRO or FSA/other authorities?
- Legal structure and status, piercing the veil, effectiveness of trust structures and process including client money and assets and SIV/off-balance sheet, intra-group agreement terms, cash management, collateral/margin and lending, national insolvency and resolution laws, EU law on winding up, settlement finality, financial collateral and regulation etc, legal entity title to business, IP and financial assets, negative pledge restrictions, key service contract provisions

## Links to useful materials

[CMS bibliography of published materials about living wills \(latest updated version\)](#)

[CMS Roadmap report - 'Regulatory change - understanding the impact' \(latest updated version\)](#)

Excerpts from the RegZone Acronym buster – click [here](#) to access the full document

Acronyms and terms	What it stands for and means
BIP	Business information pack
BRO	Business resolution officer
CoLR	Capital of last resort
DGLD	Deposit insurer's loss given default
FSMA	Financial Services and Markets Act 2000
FS Bill	Financial Services Bill, introduced into Parliament on 19 November 2009

SRR	Special Resolution Regime – a framework under the Banking Act 2009 allowing FSA, the Bank of England and Treasury to resolve a failed credit institution by transferring all or any part of it to a third party, to a publicly-controlled bridge bank or to temporary public ownership
RCP	<i>Recovery plan</i>
Recovery	The recovery of an institution from a period of stress without <i>resolution or rescue</i>
Rescue	Intervention by the state to avoid the failure/ <i>resolution</i> of an institution
Resolution	The winding down of an institution (as distinct from <i>recovery or rescue</i> )
Resolution authority	The public body responsible for overseeing and/or administering the <i>resolution</i> of a firm
RSP	<i>Resolution plan</i>
RRPs	<i>Recovery and resolution plans</i>

## Contacts



### **Paul Edmondson – FS regulation**

Partner, Financial Services  
T +44 (0) 20 7367 2877  
E paul.edmondson@cms-cmck.com



### **Simon Morris – FS regulation**

Partner, Financial Services  
T +44 (0)20 7367 2702  
E simon.morris@cms-cmck.com



### **Ash Saluja – FS regulation**

Partner, Financial Services  
T +44 (0) 20 7367 2734  
E ash.saluja@cms-cmck.com



### **Maxine Cupitt – FS regulation (insurance)**

Partner  
T +44 (0) 20 7367 2865  
E: maxine.cupitt@cms-cmck.com



### **Yuban Moodley – IT and data**

Partner, Technology and Sourcing  
T +44 (0)20 7367 3453  
E yuban.moodley@cms-cmck.com



**Barney Hearnden – corporate**  
Partner, Corporate  
T +44 (0)20 7367 2878  
E [barney.hearnden@cms-cmck.com](mailto:barney.hearnden@cms-cmck.com)



**Rita Lowe – insolvency and SRR**  
Partner, Banking  
T +44 (0)20 7367 2798  
E [rita.lowe@cms-cmck.com](mailto:rita.lowe@cms-cmck.com)



**Will Dibble - derivatives**  
Partner, Capital Markets  
T +44 (0)20 7367 3378  
E [will.dibble@cms-cmck.com](mailto:will.dibble@cms-cmck.com)