

Beware the Brave New World of Living Wills

Paul Edmondson, Partner at CMS Cameron McKenna, assesses the impact of the proposed Recovery and Resolution Plans on financial institutions.

The message to the financial services industry is clear: the days of light touch regulation are over. As legislators move to ensure that market disturbance on the global scale of the recent crisis can never happen again, financial institutions are braced for a new, tougher regulatory regime.

In the UK (although discussions on this theme are also taking place at both EU and international level), the big 'new idea' is a requirement on financial institutions to establish and operate Recovery and Resolution Plans (RRPs). For UK firms, these so-called 'Living Wills' will be subject to a new regime established by the Financial Services Bill. FSA will set the procedure and rules designed to ensure that in the event of market stress, firms have processes in place to facilitate recovery. In the event that this recovery plan becomes unviable, the authorities will implement the resolution plan: a contingency planning exercise designed to ensure that the firm can be efficiently wound down or, in the new language of this burgeoning area of regulation, 'resolved' as 'a gone concern' in a manner that protects consumers and avoids wider market disturbance.

Clues from FSA hint that living wills legislation is set to impact drastically on the financial sector. Lord Myners' recent speech to the Smith Institute referred to living wills as "one of the most radical proposals in global financial reform in a century". Political posturing aside, the question remains, what does the new world of living wills really mean for the industry? Already we know that all deposit takers, including all banks and building societies are likely to have to draft RRP's. The global pilot was launched last year and includes six of the major insurance groups (as well as major banking groups such as HSBS and Barclays). In non-bank sectors, the more onerous living wills process is likely to be extended further, possibly under the guise of a firm's systemic importance. For example, larger life offices and general insurers are in the regulators sights. Non-bank investment firms will also be caught but the precise scope of each of the new requirements (and the rules themselves) will be subject to consultation.

Living wills have two potentially onerous and costly roles. The first is a vast exercise in contingency planning. Although recovery plans will be scrutinised by regulators and be subject to their approval, firms will have considerable control over them and be responsible for tackling the host of legal and compliance issues which arise. Due diligence will be required on all the potential difficulties, such as legal barriers from the group structure or negative pledges in contracts, that might impede rapid execution of the plan.

In contrast, the resolution plan will belong to the authorities - who will be responsible for deciding how to effect resolution if failure occurs. The role of the firm here is to examine how resolution options might play out and to be ready to deliver the data and other resources that those involved in the resolution will require.

Firms will be expected to maintain a host of up-to-date business and financial information and data sets (possibly in permanent data rooms) in a form that meets FSA standards. This will include information on the group's legal, operational and business structure and much more besides. RRP's are therefore likely to transform the way in which client and other data is stored. The so-called 'Single Customer View' was announced by FSA last year. From the end of this year, banks must be able to deliver data sets giving the FSCS insured balance for each individual customer across all the different brands of that bank entity.

Removing impediments to resolution may include a requirement to 'insolvency proof' their contracts with key staff and service suppliers, so that an administrator will not lose these resources as soon as he is appointed. A special reserve may be needed to fund the costs of these contracts during the administration. There will be an increased emphasis on internal policemen within financial institutions. For the purpose of establishing and implementing living wills, a new board-level role is planned. The business resolution officer, a sort of in-house funeral director, will be responsible for on-going compliance with the new requirements. This includes the need for management to consider how changes, such as acquisitions, will impact their RRP's. Not only will plans have to be updated; in some cases the potential impact on resolution may prevent the deal taking place at all.

On one level, living wills are a contingency planning exercise on a very grand scale. However, this new regulatory tool has another potentially even more revolutionary role. RRP's are a logical extension of stress testing in that they plan for the contingencies not covered by the stress-testing assumptions. This switch to disaster-mode thinking links to the broader reappraisal of capital and liquidity standards, and the impact of the increased role of contingent capital. The authorities are only just starting to get to grips with many of the lessons from the crisis that fall within the new mantras of macro-prudential regulation and systemic risk. To help them, the authorities will have access to a mass of new information derived from firm and industry level stress testing and the new requirements for reverse stress testing 'back from failure'.

The question is what good this will do. How will the information be used? The living wills process provides an ideal

opportunity for regulators to address many of these macro-prudential mechanism brain teaser problems: the belief that institutions have become, and in future must be prevented from being, too big or complex or inter-connected to fail. The RRP process provides the tool for the regulator to probe these issues without having to devise hard-edged and highly controversial Volcker style rules.

This may be the regulators' instrument of choice because it puts the onus back on each financial institution to prove that it can fail without taxpayers' money or broader contagion being at risk. The Bank of England has stated that in assessing RRP, regulators must consider whether "with this structure and business model can I [the resolution authority] achieve a resolution at an acceptable cost" - essentially, would the consequences of an institution failing be so uncertain or dangerous that the authorities might have to mount a rescue with taxpayers' money?

Armed with this mass of new information, the authorities can challenge each firm according to this criteria, looking at issues such as at its business models, structure, scale and risk. From its draft living will, an institution may be judged by the new 'bad cop' FSA to pose too great a risk, on account of its size, complexity or its role within the financial system. In retail sectors, an institution may be challenged if its failure threatens potentially large uninsured consumer losses. As the authorities learned in the recent crisis, financial stability concerns, as well as political pressure, can dictate that the government rescues a failing firm rather than enforcing the principle of moral hazard against the consumer.

RRPs provide a regulator friendly tool to address that most fundamental issue which politicians have debated in simplistic terms: should the banks be broken up? This is the potentially radical endpoint of the living will process.

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