



The Will to Live: Recovery and Resolution Plans for UK Banks

Making a will is regarded by most individuals as a necessary irritant ranking in popularity somewhere below a visit to the dentist or doctor. Following the unprecedented instability in the global financial markets since 2007, “systemic” risk (posed by the potential failure of large or complex cross-border financial institutions) was identified by regulators and legislators as one of the key areas requiring better supervision, in order to prevent a similar crisis in the future. This led to a call for banks and financial institutions to set out detailed plans or “living wills” to seek to wind-down their operations in an insolvency scenario with the least impact on the stability of the financial sector.

Financial Stability and Depositor Protection: Strengthening the Framework

In January 2008, in a consultation paper titled “Financial stability and depositor protection: strengthening the framework,” the UK’s HM Treasury (“HMT”) first set out the proposition that “banks need to be adequately prepared to minimise the disruption arising from their own failure.”¹ This envisaged that an appropriate regulatory response to the financial crisis would be comprised of two parts:

- the introduction of a special resolution regime (“SRR”) empowering regulators with the tools to resolve a failing bank in an orderly manner, and
- a requirement that banks establish internal plans and arrangements designed to minimise the impact of their failure in the event of financial stress.

We consider below the proposals relating to the recovery and resolution plans (“RRPs”) or “living wills” in the context of the wider debate concerning financial regulation.

Banking Act of 2009 and the Special Resolution Regime

The UK government has responded to the banking crisis not only with a series of bank rescue and support measures but also with a comprehensive review and reform of existing banking regulation. The Banking Bill was introduced on 7 October 2008 and resulted in the enactment of the Banking Act 2009, which came into effect on 21 February 2009.

The Banking Act 2009 (Part 1) implements a permanent version of the SRR, which had previously been introduced as an emergency temporary response to the credit crisis under the Banking (Special Provisions) Act 2008,² which expired in February 2009. The SRR provides the HMT, the Bank of England (“BOE”) and the Financial Services Authority (“FSA”) (collectively, the “Tripartite Authorities”) with new “stabilisation” tools to ensure the effective, orderly resolution of deposit-taking institutions, whereby they may transfer part or all of the

¹ HM Treasury consultation paper: Financial stability and depositor protection – strengthening the framework (30 January 2008), http://www.hm-treasury.gov.uk/d/banking_stability_pu477.pdf.

² Banking (Special Provisions) Act 2008, http://www.opsi.gov.uk/acts/acts2008/ukpga_20080002_en_1.

bank's business, shares, assets, rights and liabilities (1) to a private sector purchaser, (2) to a publicly controlled "bridge bank" (which will be wholly owned by BOE) or (3) to temporary public sector ownership (i.e., nationalisation).³

The Banking Act 2009 (Part 7) also authorises HMT to enact regulations to create a new "investment bank insolvency procedure" for UK investment banks which hold client money or assets. From 11 May to 10 July 2009, HMT conducted a public consultation on its initial thoughts on the reforms that may be needed to develop effective resolution mechanisms for investment banks, in light of the deficiencies in the current insolvency regime revealed from the failure of Lehman Brothers.⁴ On 16 December 2009, HMT published a further consultation paper, which reflects the results of that consultation and outlines over 30 detailed policy initiatives designed to mitigate the impact of an investment firm's failure. These initiatives include a new requirement for investment firms, to be mandated by FSA rules, to implement "investment firm resolution plans" (i.e., the investment banking component of RRP currently being legislated in the Financial Services Bill).⁵ Comments may be made on the proposals until 16 March 2010.

The Turner Review: A Regulatory Response to the Global Banking Crisis

On 18 March 2009, the FSA published a comprehensive set of proposals aimed at addressing the risks posed by "systemically important" financial institutions in the Turner Review and the associated FSA Discussion Paper (DP09/2).⁶

The proposals ranged from enhanced supervision and governance (including remuneration arrangements), regulatory capital and liquidity requirements, international coordination in the regulation and supervision of global cross-border banks (e.g., by the establishment of "colleges of supervisors" comprising the regulators from the main countries in which a bank operates), to the operation of crisis coordination mechanisms and cross-border contingency plans over such banks.

HM Treasury White Paper: Reforming Financial Markets

On 8 July 2009, HMT published a white paper on "Reforming Financial Markets," which focused on measures to better monitor and manage systemic risk, including a specific proposal to require systematically important firms to develop, and submit to the FSA for approval, RRP or living wills.⁷

HMT stated that they believed regulators had underestimated the extent of systemic risk and the system-wide implications of various financial engineering techniques and innovations. In particular, they concluded that the increasing use of securitisations and derivatives instruments by financial institutions may have inadvertently led to an increase in systemic risk by creating an increasingly complex network of interdependence. As a result, the failure of one large international financial institution could have severe repercussions on other institutions and even threaten the rest of the financial system as a whole, across national frontiers.

³ See Morrison & Foerster client bulletins: Update on the UK Government's Banking Support Measures and the Banking Act 2009 (30 March 2009), <http://www.mofo.com/news/updates/files/090330UKBank.pdf>; UK Government's Banking Support Measures (4 February 2009), <http://www.mofo.com/news/updates/files/090204UKGovernmentsBankingSupportMeasures.pdf>.

⁴ HM Treasury discussion paper: Developing effective resolution arrangements for investment banks (11 May 2009), http://www.hm-treasury.gov.uk/d/consult_investmentbank110509.pdf. See also Developing effective resolution arrangements for investment banks: Consultation responses, available at http://www.hm-treasury.gov.uk/consult_investment_banks_responses.htm.

⁵ HM Treasury consultation paper: Establishing resolution arrangements for investment banks (2 November 2009), http://www.hm-treasury.gov.uk/d/consult_investmentbank161209.pdf.

⁶ Turner Review: A regulatory response to the global banking crisis (18 March 2009), http://www.fsa.gov.uk/pubs/other/turner_review.pdf, and the associated FSA Discussion Paper (DP09/2): A regulatory response to the global banking crisis (18 March 2009), http://www.fsa.gov.uk/pubs/discussion/dp09_02.pdf.

⁷ HM Treasury White Paper: "Reforming Financial Markets" (8 July 2009), http://www.hm-treasury.gov.uk/d/reforming_financial_markets080709.pdf. See also Morrison & Foerster client bulletin: "UK White Paper on Reforming Financial Markets" (9 July 2009), http://www.mofo.com/news/updates/files/090709UK_White_Paper.pdf.

Accordingly, it was perceived as imperative that the Tripartite Authorities work together to ensure that “all banks are adequately prepared and organised internally for their own resolution,” by establishing clear contingency plans in advance of financial distress or failure to enable timely action in response. HMT stated that a bank’s RRP:

- will be an integral factor in the FSA’s overall assessment of the prudential risks borne by the firm, with possible bearing on its regulatory capital and/or liquidity requirements;
- should be proportionate to the size and complexity of the particular firm, and should include an assessment of how difficult it will be to resolve; and
- may necessitate revision (i.e., simplification) of some firm’s corporate structures, e.g., by establishing clear lines between deposit-taking and other operations, so that the depositor book can be easily sold to another firm in times of failure with minimum disturbance to the wider financial system, thus maintaining depositor confidence.

Feedback on the Turner Review and FSA DPO9/2 and the Turner Review Conference

The FSA maintains that the UK is leading the effort by national regulators in developing RRPs and could provide the blueprint for international initiatives.

In September 2009, the FSA published its Feedback Statement (FSO9/3)⁸ reporting on the feedback received on the Turner Review consultation, including the ongoing debate and consideration of RRPs or living wills. The FSA proposes in the statement that all systematically important financial institutions be required to develop and submit RRPs to the FSA for approval.

On 22 October 2009, in anticipation of the second Turner Review Conference on 2 November 2009,⁹ the FSA published a Discussion Paper (DPO9/4) concerning large systemically important banks, including a proposal to require RRPs or “living wills.”¹⁰ The consultation is open for comments until 1 February 2010.

In DPO9/4, the FSA set out three possible policy responses aimed at minimising the probability and ultimate consequences of failure for systemically important firms:

1. Making systemically important firms smaller or less interconnected (i.e., less systemically significant).

This could take the form of reducing the web of contracts between major firms and/or separating narrow banking (e.g., retail) from riskier proprietary trading (i.e., commercial) activities.

2. Reducing the probability of failure to a very low level (far lower than for smaller, non-systemically important banks).

This may be achieved by imposing higher capital and/or liquidity requirements or by requiring that regulatory capital be wholly or predominantly in common equity. Where other forms of capital are allowed, they should be capable of bearing loss whilst the firm remains a going concern. The FSA has explicitly mentioned that certain hybrid instruments, such as contingent convertibles (i.e., contingent capital that converts into common equity if the firm’s capital ratio reaches a certain threshold), would be acceptable, as they set up a “pre-pack recapitalisation” of the firm. Such arrangements could facilitate a

⁸ FSA Feedback Statement (FSO9/3): A regulatory response to the global banking crisis – Feedback on DPO9/2 (30 September 2009), http://www.fsa.gov.uk/pubs/discussion/fs09_03.pdf.

⁹ Turner Review Conference: Large systemically important banks: addressing the too big to fail problem (2 November 2009), <http://www.fsa.gov.uk/pages/Doing/Events/turner.shtml>.

¹⁰ FSA’s Turner Review Conference Discussion Paper (DPO9/4): A regulatory response to the global banking crisis: systemically important banks and assessing the cumulative impact (22 October 2009), http://www.fsa.gov.uk/pubs/discussion/dpo9_04.pdf.

winding-up without exposing the taxpayers to yet more risk, thereby providing the added benefit of reducing the “moral hazard” of government bailouts.

3. Increasing the likelihood that a systemically important firm will be allowed to fail.

The object is to put in place the conditions that would permit a range of options other than a whole bank rescue to be considered. Such options would involve imposing losses on some non-equity claims or compelling a simplification of the firm’s legal structure as part of the RRP.

The Financial Services Bill

The Financial Services Bill (the “Bill”)¹¹ is a product of the public consultation conducted pursuant to the HMT White Paper in July 2009 and seeks to legislate the RRP for all systemically important banks and other financial institutions in the UK as part of a comprehensive response to the banking crisis. The Bill provides, *inter alia*, for:

- creating a Council for Financial Stability (“CFS”) to coordinate the actions of the Tripartite Authorities with respect to financial stability matters;
- mandating the FSA to make rules requiring all FSA authorised firms to create and maintain RRP; and
- requiring the FSA to work with other national and global regulators towards the development of international standards of regulation and supervision.

According to the HMT’s Frequently Asked Questions on the Financial Services Bill, RRP are regarded as a “key tool for authorities and firms to mitigate risks that individual firms pose to the system, and to promote long-term financial stability.”

The Bill was introduced to the UK Parliament on 19 November 2009 and is currently being debated.¹²

The current views of the HMT and the FSA can be garnered from the House of Commons’ Treasury Committee First Special Report of Session 2009-10,¹³ published on 27 November 2009, which set out their respective feedback:

HMT’s comments

RRP aim to prepare firms for stressed circumstances to enhance their prospects of “recovery,” as well as for potential failure to enable an effective “resolution” with minimal repercussions on the financial system.

The quality of a bank’s RRP should have a direct bearing on supervisors’ overall assessment of the prudential risks borne by the firm. In particular, the FSA should be justified in deciding whether to impose additional capital requirements on the basis of a firm’s potential systemic impact. Thus, the RRP will create regulatory incentives for firms to become less risk-embracing.

The FSA’s comments

Referring to its statements in DP09/4, the FSA reiterates its support for the proposal that each bank shall prepare an RRP which is subject to regular evaluation by the BOE.

¹¹ Financial Services Bill, http://www.hm-treasury.gov.uk/fin_bill_index.htm. See also HM Treasury’s Frequently Asked Questions on the Financial Services Bill, http://www.hm-treasury.gov.uk/fin_bill_faqs.htm. For more recent political background, see “Statement on banking reform” by the Chancellor of the Exchequer Alistair Darling (3 November 2009), http://www.hm-treasury.gov.uk/statement_chx_031109.htm.

¹² See Bills before Parliament 2009-10: Financial Services Bill, <http://services.parliament.uk/bills/2009-10/financialservices.html>.

¹³ House of Commons’ Treasury Committee First Special Report of Session 2009-10 (27 November 2009), <http://www.publications.parliament.uk/pa/cm200910/cmselect/cmtreasy/47/47.pdf>.

Improving bank resolution mechanisms is a vital component of financial services sector reform. At present, the lack of appropriate means by which large, complex banks can be resolved encourages complacency in these banks, contributing to the “moral hazard.” The SRR is an important mechanism, but its usefulness is reduced because the Tripartite Authorities are not able to cope effectively with the resolution of large, complex banks due to a lack of information about how such banks are internally structured. In particular, RRP’s must identify the actions that firms would need to take to enable the authorities to use the SRR tools (or for the firm to be placed into insolvency).

Furthermore, the FSA states that it intends to impose additional requirements on systemically important firms, depending on the following three categories:

- a demonstration that they can quickly provide the authorities with the data necessary for them to assess the resolution options;
- an analysis of the potential barriers to the authorities’ exercise of the SRR powers; and
- an analysis of how the firm could ‘unplug’ itself from the payments, clearing and settlement systems, without damaging the infrastructure.

Once a firm has produced its RRP, it will be subject to review by the FSA, in consultation with the BOE. The FSA will assess the risks identified by these plans and the recovery and resolution actions proposed by the firm to mitigate them. For some firms, this may in turn necessitate structural changes (e.g., where its existing corporate structure could hinder the implementation of the plans) and/or off-setting measures (e.g., additional capital and/or liquidity requirements).

The FSA will work closely with the BOE and HMT, as well as international counterparts through the Financial Stability Board (“FSB”), in order to develop common approaches to the extent possible, whilst recognising that RRP’s will need to be tailored to the local insolvency regimes in different jurisdictions.

Other Indications of What the RRP’s May Entail

Further indications of the required elements and the mechanics of compliance with the compulsory RRP’s can also be found in various official statements.

Mervyn King, BOE’s Governor – 17 June 2009

On 17 June 2009, speaking at the Lord Mayor’s Banquet for Bankers and Merchants of the City of London at the Mansion House (the “Mansion House Speech”),¹⁴ BOE Governor Mervyn King proposed that each regulated bank be required to produce “a plan for an orderly wind down of its activities” and called on banking regulators “to work across national boundaries to identify detailed plans for how each large cross-border financial institution could be wound down.”

Paul Myners, HMT’s Financial Services Secretary – 18 September 2009

In a speech at the Financial Times Global Finance Forum on 18 September 2009,¹⁵ HMT’s Financial Services Secretary Paul Myners discussed the planned legislation (subsequently embodied in the Financial Services Bill) that will require banks and other financial institutions to draw up RRP’s. Whilst acknowledging the need for the details yet to be worked out, he outlined some of the HMT’s thinking as follows:

¹⁴ Speech by Mervyn King, Governor of the Bank of England, at the Lord Mayor’s Banquet for Bankers and Merchants of the City of London at the Mansion House (17 June 2009), <http://www.bankofengland.co.uk/publications/speeches/2009/speech394.pdf>.

¹⁵ Speech by Paul Myners CBE, Financial Services Secretary to the HM Treasury, “Developing a new financial architecture: lessons learned from the crisis,” at the Financial Times Global Finance Forum (18 September 2009), http://www.hm-treasury.gov.uk/press_82_09.htm.

- RRP are more in the nature of “pre-structured euthanasia” than “living wills.” Systemically important firms will have to designate an internal “undertaker” to take charge of the process. For some banking groups this will mean simplifying structures and reducing complexity.
- Banks will have to produce clear plans of “how to reorganise or de-risk,” should they encounter financial difficulty including the disposal of residual businesses following resolution.
- In addition, RRP will become key elements of the FSA’s “risk assessment framework and prudential supervisory processes.”

Mervyn King, BOE's Governor – 20 October 2009

On 20 October 2009, speaking to the Scottish Business Organisations in Edinburgh, BOE Governor Mervyn King asserted that deficiencies in the structure and regulation of the banking sector had been one of the two key underlying causes of the financial crisis, the other cause being global imbalances.¹⁶

As regards the second cause, Mervyn King called attention to the “too important to fail” problem, which was distorting the incentives (or approaches to risks) of some banks. He outlined two possible approaches to dealing with this problem:

- ensuring that the probability of those institutions failing, and hence of the need for taxpayer support, is extremely low; and/or
- finding a way that institutions can fail without imposing unacceptable costs on the rest of the economy.

The first approach could be achieved through better regulation (e.g., higher capital requirements). Nevertheless, in a highly interconnected financial system, the failure of an important institution could contaminate the rest of the (real) economy. Therefore, the structure of the financial industry (or firms) may also need to be changed, so that the essential – or utility – services that the banks provide to the wider economy are insulated from their other activities.

As he had argued in his Mansion House Speech in June, the BOE Governor reiterated that, regardless of the approach adopted, financial institutions should be required “to plan for their own orderly wind down – to write their own will.” He acknowledged that the outcome of this exercise may be the separation of activities, or increasingly detailed regulatory oversight at the cost of innovation and efficiency in the financial industry.

Andrew Bailey, BOE's Executive Director for Banking Services & Chief Cashier – 17 November 2009

In a speech at the Santander International Banking Conference in Madrid on 17 November 2009,¹⁷ Andrew Bailey, BOE’s Executive Director for Banking Services and Chief Cashier, described the role of the RRP as follows:

- the *recovery* component of the RRP is a bank’s “internal blueprint for recovery in a crisis.” As such it should encompass contingency funding plans and use of contingent capital instruments as well as sale of assets and/ or business lines; and
- the *resolution* component of the RRP only comes into play if recovery is no longer feasible, so it should highlight “where structures need to be changed” in order to facilitate “an orderly death.”

He cited Northern Rock plc (which was nationalised in February 2008) and Lehman Brothers International (Europe) (“LBIE”) (which entered into administration in September 2008) as cases in point to illustrate the importance of having RRP in place.

¹⁶ Speech by Mervyn King, Governor of the Bank of England, to the Scottish Business Organisations, Edinburgh (20 October 2009), <http://www.bankofengland.co.uk/publications/speeches/2009/speech406.pdf>.

¹⁷ Speech by Andrew Bailey, Executive Director for Banking Services & Chief Cashier of the Bank of England, at the Santander International Banking Conference in Madrid (17 November 2009), <http://www.bankofengland.co.uk/publications/speeches/2009/speech412.pdf>.

- A recovery plan would have helped Northern Rock’s management understand and address the following key risks:
 - how its business model could counteract the closure of its key funding markets, given its heavy dependence on securitisation; and
 - how it could cope with serious financial stress, given its business model of aggressively pursuing market share by squeezing its net interest margin and accepting more borrower default risk.
- In the case of LBIE, two key issues relevant to its resolution were:
 - what its RRP should have contained by way of resolution options; and
 - what changes to its organisation and operations might have made it more straightforward to deal with its collapse.

More specifically, a resolution plan for LBIE should have included:

- a detailed balance sheet for all the corporate entities in the group at the most recent month end;
- a clear mapping of financial and operational interdependencies between affiliates;
- wind-down plans for all business areas linked to a comprehensive information data room; and
- a contact plan for major stakeholders.

In turn, LBIE’s corporate structure should have been revised as follows:

- corporate entity based accounts and management information supplementing the business-line version;
- clear segregation of client asset handling activities;
- controls over depositing client money with affiliates;
- employees hired by the entity for whom they work;
- a clear record of each entity’s title to business and associated intellectual property;
- robust risk systems that allow ready provenance of the balance sheet;
- contracts for the provision of key business services, including banking systems, that allow continuity of provision of services in the event of a resolution; and
- arrangements for continuity of access to payment and settlement systems.

Paul Tucker, BOE’s Deputy Governor, Financial Stability – 16 November 2009

On 16 November 2009, Paul Tucker, BOE’s Deputy Governor, Financial Stability, announced that firms would have to draw up RRP’s in the next 6 to 9 months.¹⁸ Press sources have since reported that the FSA has begun pilot-testing the “living wills” exercise with certain banks.¹⁹

G20 and the FSB

The G20 are also seen as generally supportive of the “living wills” concept, despite objection from some firms which argue that it is almost impossible to draft such a plan in advance without knowing the cause of any future

¹⁸ Speech by Paul Tucker, Deputy Governor, Financial Stability, Bank of England at SUERF, CEPS and Belgian Financial Forum Conference: Crisis Management at the Cross-Road, Brussels (16 November 2009),

<http://www.bankofengland.co.uk/publications/speeches/2009/speech410.pdf>.

¹⁹ See, e.g., “FSA’s powers to demand ‘living wills’ may stretch beyond banks” (Guardian, 19 November 2009),

<http://www.guardian.co.uk/business/2009/nov/19/fsa-living-wills-financial-services-bill>; “Thirty groups on systemic risk list” (Financial Times, 30 November 2009), http://www.ft.com/cms/s/0/c680e0da-dd4e-11de-ad60-00144feabdco.html?nclick_check=1.

crisis. In the Communiqué issued on 7 November 2009 following a meeting of the Finance Ministers and Central Bank Governors in St. Andrews,²⁰ the G20 cited the FSB's pending work to reduce the "moral hazard" problem and called for the "rapid development of internationally consistent, firm-specific recovery and resolution plans and tools by end-2010."

The FSB is reportedly running a list of 30 systemically important cross-border financial institutions, consisting of 24 banks and 6 insurance companies, which they regard as posing a significant risk to the global financial system.²¹ These institutions are deemed to warrant special regulatory oversight on a cross-border basis through newly established colleges of supervisors.

Conclusion

As discussed above, whilst the UK Parliament continues to deliberate on the Financial Services Bill, including the provisions relating to RRP, the FSA has been engaged in piloting exercises with some of the larger UK banks for the development of suitable RRP.

Meanwhile some global banks are already restructuring themselves to separate their retail (or utility) banking business from their commercial and investment banking arms. For example, Barclays Group announced major restructuring plans on 3 November 2009, which will segregate its retail banking business from its corporate and investment banking business.²² It is entirely possible that other banks may follow.

We will continue to monitor further developments and provide updates on the details of the RRP which financial institutions will be required to establish (such as the specific contents required to be included in the plans, the ongoing obligations for their review and revision and the mechanics of compliance), as well as the extent of the related supervisory powers which may be given to the FSA (e.g., the review, approval, implementation or enforcement of the plans).

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Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations.

²⁰ G20 Communiqué: Meeting of Finance Ministers and Central Bank Governors, United Kingdom (7 November 2009), www.g20.org/Documents/2009_communique_standrews.pdf.

²¹ See, e.g., "Thirty groups on systemic risk list" (Financial Times, 30 November 2009), http://www.ft.com/cms/s/0/c680eoda-dd4e-11de-ad60-00144feabdco.html?ncklick_check=1. The article reports that the FSB's list contains 6 insurance companies ("Axa, Aegon, Allianz, Aviva, Zurich and Swiss Re") and 24 banks ("Goldman Sachs, JPMorgan Chase, Morgan Stanley, Bank of America Merrill Lynch and Citigroup of the US; Royal Bank of Canada; UK groups HSBC, Barclays, Royal Bank of Scotland and Standard Chartered; UBS and Credit Suisse of Switzerland; France's Société Générale and BNP Paribas; Santander and BBVA from Spain; Japan's Mizuho, Sumitomo Mitsui, Nomura, Mitsubishi UFJ; Italy's UniCredit and Banca Intesa; Germany's Deutsche Bank; and Dutch group ING").

²² Barclays Group press release, "Barclays Broadens Executive Committee" (3 November 2009), <http://www.newsroom.barclays.com/content/Detail.aspx?ReleaseID=1648&NewsAreaID=2>.