



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 consultation is open for responses until 24 September 2012. It asks 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 is “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 below.

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 legislate 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 incorporated 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.

1.3 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

¹ Directive 2006/49/EC

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.

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