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UK Regulatory Proposals on Removing Impediments to Resolvability

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The Bank of England, the UK authority with powers to "resolve" failing banks, is consulting on how it might exercise its power of direction to remove impediments to resolvability. The Bank may require measures to be taken by a UK bank, building society or large investment firm to address a perceived obstacle to credible resolution. Concurrently, the Prudential Regulation Authority is proposing to impose a rule that would require a stay on termination or close-out of derivatives and certain other financial contracts to be contractually agreed by UK banks, building societies and investment firms with their non-EEA counterparties. This note discusses the proposed approaches by the UK regulators to ensuring that impediments to resolvability are removed, as well as certain cross-border implications.

Introduction

Under the EU Bank Recovery and Resolution Directive ("BRRD"), a resolution authority must prepare a resolution plan for all credit institutions (banks and building societies) and certain large investment firms (each a "firm") which, amongst other things, sets out the preferred resolution strategy for the firm. The resolution authority must also assess the resolvability of the firm, without assuming that the firm would receive any extraordinary public taxpayer/government financial support or central bank liquidity assistance. If a material impediment to the resolvability of a firm is identified, the resolution authority may, in consultation with the firm's national regulator, require the firm to address the impediment.

EU resolution authorities also have the power to temporarily suspend the termination rights of any party to a contract with a firm under resolution if the firm continues to perform its payment, delivery and collateral obligations under the contract. In addition,

the BRRD provides that a pre-resolution or resolution action by a resolution authority or national regulator does not give rise to a counterparty's right to terminate a contract with a firm or to exercise rights over collateral.

In the UK, the Bank of England (the "Bank") is the relevant resolution authority for purposes of the BRRD and as such is responsible for preparing resolution plans for relevant UK firms and for making resolvability assessments. The Bank is consulting on its proposed approach[1] to using its powers of direction to remove impediments to resolvability.

The Bank, like all EU resolution authorities, also has the power to temporarily suspend termination rights. Any exercise by the Bank of that power would automatically be recognized and given effect throughout the EU. However, it is uncertain whether the court of a non-EU country would enforce the temporary stay on exercise of termination rights under a contract governed by that non-EU country's law or as against a non-EU counterparty. Currently, there is no international norm or treaty for cross-border recognition of resolution or private international law measures and reliance is still being placed on regulators being able to coordinate, cooperate and agree with one another internationally. The EU Directive on the reorganization and winding-up of credit institutions sets out such a regime within the EU and also provides for the mutual recognition and enforcement of decisions on the reorganization and winding-up of credit institutions with branches in Member States other than those in which they have their head office. This ensures that any exercise of resolution powers or use of resolution tools under the BRRD will be recognized and enforced in other Member States provided national regulators are notified of the resolution measures. Absent any international framework for recognition of resolution actions globally which would assist in ensuring credible resolvability of global financial groups, some regulators, including the UK's Prudential Regulation Authority ("PRA"), are considering imposing requirements on firms in their jurisdictions that would provide contractual solutions to the problem.

Powers of Direction to Remove Impediments to Resolvability

Before exercising its powers of direction to remove any impediments to the resolvability of a firm, the Bank will consult with the PRA and Financial Conduct Authority ("FCA") and once a final decision is reached, will continue to coordinate with both. The Financial Policy Committee must also be consulted where appropriate. Depending on the nature of the impediment to resolvability, the Bank may either use its power of direction or it may propose that the PRA takes steps requiring the firm to address the impediment.

A direction by the Bank must be given in writing and be accompanied with a notice which states when the direction takes effect, the reasons for the direction and the time within which a firm may make representations to the Bank about the direction. The notice which accompanies a direction from the Bank must set out how the measures will address the impediments in a proportionate manner. A direction may be of general application or be addressed to a particular firm or to a type of firm.

The Bank may use its powers of direction after conducting a resolvability assessment or at any time that it considers it necessary to direct a firm to take steps so that there are no obstructions to the use of the Bank's stabilization powers or the winding up of a firm. In its proposed Policy Statement, the Bank sets out the proposed timeframe and process for directions following a resolvability assessment which includes allowing the firm four months to propose remedial measures of its own after the Bank notifies the firm of any substantive impediment. If the Bank considered the firm's proposal insufficient, the Bank would have to use its powers of direction to address the impediment. A firm would have one month from receipt of a direction to propose a plan to implement the Bank's requirement. However, where

[1] The consultation paper is available at: http://www.bankofengland.co.uk/financialstability/Documents/role/risk_reduction/srr/cp/resolutiondirectinstitutions.pdf.

the Bank needs to take action outside of the resolvability assessment process, for example, in order to act quickly to address an impediment prior to placing the firm into resolution, an alternative process may need to be utilized with much tighter timeframes.

Scope of Powers

The Bank's powers of direction for removing obstacles to resolvability apply to:

- banks, building societies and certain large investment firms[2] authorized by the PRA or FCA, which includes the nine largest broker-dealers in the UK;[3]
- parents of the above firms that are financial holding companies or mixed financial holding companies and that are established in the UK; and
- any subsidiaries of such firms or their parents that are financial institutions, authorized by the PRA or the FCA and established in the UK.

The Bank has the power to require a firm to implement any of the non-exhaustive list of measures set out in the BRRD to ensure resolvability of the firm. These include, among others: (i) imposing additional information requirements; (ii) requiring a firm to dispose of assets or to cease specific activities; (iii) requiring a firm to issue eligible liabilities; (iv) restricting maximum individual and aggregate exposures; and (v) requiring a firm to change its legal or operational structure. Notably, a firm or parent entity may also be required to establish a parent financial holding company in a Member State. The European Securities and Markets Authority's guidelines[4] on measures to reduce or remove impediments to resolvability states that resolution authorities should also consider measures for removing impediments that exist or arise in non-EU countries.

The Bank's proposed Policy Statement included in its consultation paper sets out a list of possible scenarios in which the Bank might consider exercising its power of direction. These include:

- issuance of liabilities at parent company level to provide for loss absorption and recapitalization of group entities;
- establishment of funding arrangements that would allow losses to be transferred to the legal entity which will be resolved where the funding of subsidiaries by the parent is not adequately subordinated or subject to set-off;
- arrangements to ensure continuity of contracts, operational services, access to payment services and to financial market infrastructures; and
- restructuring post-resolution involving a bail-in so that a business line and/or legal entity could continue, be unwound or transferred.

The Bank's powers are wide-ranging but, in practice, dialogue between the firm, the Bank and the regulators would be expected to address any weaknesses in a resolution plan or the resolvability of a firm, preventing the Bank from having to exercise its most draconian powers. In that sense, the powers are a last resort for the Bank to ensure that a firm is resolvable in a credible manner.

[2] Investment firms that deal in principal and are required to hold initial capital of EUR730,000.

[3] Barclays Capital Securities Limited, Citigroup Global Markets Limited, Credit Suisse Securities (Europe) Ltd, Goldman Sachs International, Merrill Lynch International, Mitsubishi UFJ Securities International plc, Morgan Stanley & Co. International Plc, Morgan Stanley Securities Ltd and Nomura International Plc.

[4] ESMA was required to prepared the guidelines under the BRRD. The guidelines are applicable to EU resolution authorities.

The Bank of England's Proposed Approach to Exercising its Powers of Direction

Where more than one barrier to resolvability has been identified, the Bank will prioritize dealing with the barriers. The firm will be required to adopt a staged approach to implementing the measures required, with the most material impediments being addressed first.

A direction will include the timeframe within which the Bank expects the measures to have been implemented. The timing will vary depending on the expected time it will take to implement a measure as well as the involvement of resolution colleges for cross-border firms. Progress will be monitored by the Bank.

The Bank may make its directions public, depending on the circumstances and whether it would be appropriate to do so.

The Bank has a range of measures available to it should a firm fail to comply with a direction, including publishing a statement of the failure, imposing a penalty on the firm, directing the firm to cease any action and prohibiting individuals from holding a senior management position. If the Bank considers that a firm might fail to comply with a direction, it may apply to a court for an injunction preventing non-compliance.

A firm that disagrees with the Bank's assessment that there are impediments to resolvability may appeal the Bank's determination. Similarly, where a firm proposes measures to remove impediments identified by the Bank but the Bank concludes that those proposed measures would not be sufficient to address the impediment, the firm may appeal the Bank's decision. Finally, a firm may also appeal the use of the Bank's power of direction. All such appeals would be made by referring the matter to the Upper Tribunal.[5] The Bank is a public body and is subject to public law requirements of acting reasonably, following procedures fairly and acting within the confines of its powers. A firm which exhausts the Upper Tribunal route and is still unsatisfied with the outcome might also therefore still be able to challenge the Bank's direction or use of its powers through judicial review.

International Recognition of Resolution Actions

The BRRD introduced resolution colleges designed to ensure cooperation at all stages of resolution planning and actual resolution of cross-border groups within the EU. The colleges are made up of relevant national regulators, resolution authorities, ministries, central banks, authorities responsible for deposit guarantee schemes and the European Banking Authority. Resolution authorities of non-EU countries are able to participate as observers, subject to confidentiality requirements in their country being assessed as equivalent to those under EU laws.[6] For groups operating on a cross-border basis within Europe, and where the Bank is the group-level resolution authority, the Bank must establish a resolution college. Under the BRRD, the resolution college will then be responsible for resolution planning and resolvability assessments. Any measures to address identified impediments to resolvability must be agreed within the college. However, if no agreement can be reached, the Bank (as group-level resolution authority) may then decide on its own what measures need to be taken at group-level and the resolution authorities for each material subsidiary can decide measures for each subsidiary.

[5] The Upper Tribunal is an appellate tribunal created by the Tribunals, Courts and Enforcement Act 2007. The Tax and Chancery Chamber is the part of the Upper Tribunal tasked with hearing references on certain decisions of the Bank, FCA, PRA, the Pensions Regulator or an independent valuer appointed under the Banking Act 2009.

[6] ESMA consulted earlier this year on draft regulatory technical standards on the operational functioning of resolution colleges which include a process for the group-level resolution authority of a resolution college to assess the equivalence of the confidentiality regime of a third country upon the request of a third country resolution authority to join a resolution college. The consultation paper is available at: https://www.eba.europa.eu/documents/10180/932712/EBA-CP-2014-46+(CP+on+draft+RTS+on+Resolution+Colleges).pdf.

EU resolution colleges must be established where a non-EU firm has subsidiaries or significant branches established in multiple EU member states. The EU resolution college must act as the resolution authority for the subsidiaries established in the EU and, to the extent relevant, for significant branches. Until such time as a formal cooperation agreement is agreed between the EU and a third country, a resolution authority within the EU resolution college may refuse to recognize or enforce any third country resolution proceedings if the resolution authority considers, amongst other things, that such actions would threaten the financial stability of its home member state or that the effects of its recognition or enforcement would be contrary to the laws of its member state. Crisis Management Groups for the larger financial institutions are expected to remain in place and to operate alongside the resolution colleges and EU resolution colleges.

At international level, the Financial Stability Board ("FSB") is expected to issue final guidelines by November 2015 on core elements of statutory and regulatory frameworks for recognition of foreign resolution actions which will enable domestic authorities to take supporting action to give effect to foreign resolution actions. In addition, the FSB will publish key principles to support contractual clauses recognising foreign resolution actions in debt contacts. While statutory recognition would create greater legal certainty and be more enforceable than contractual approaches, the FSB is promoting the use of contractual solutions as an interim solution because statutory recognition frameworks will take time to implement.

The PRA proposed a rule in May this year[7] that would prohibit certain firms from creating new obligations or materially altering an existing obligation under a financial contract governed by the law of a non-EEA jurisdiction unless the counterparty agreed to be subject to: (i) the Bank's power to suspend temporarily the termination rights of a party to a contract if the UK firm continues to perform its substantive obligations under the contract; and (ii) the rule that a resolution or pre-resolution action by any of the Bank, the PRA or FCA does not give rise to a right to terminate a contract with a UK firm or to exercise rights over collateral. The rule would apply to UK banks, building societies and investment firms authorized by the PRA, their financial holding companies and mixed financial holding companies as well as credit institutions, investment firms and financial institutions that are subsidiaries of any such firms or their parent entities, regardless of their location. This means that firms will also need to ensure that any subsidiary financial institutions, such as brokers, asset managers, insurers and intermediate holding companies, that trade in the relevant derivative product under contracts governed by a third country law, also obtain the necessary agreement from their counterparties. The proposed rule would not apply to contracts with designated payment and securities settlement systems, CCPs, central banks and central governments. It is unclear, however, whether the proposed rule would cover customer/clearing member contracts or indirect clearing contracts.[8]

The proposed rule is intended to ensure that any UK stay over the termination of financial contracts such as securities contracts, commodities contracts, futures and forwards contracts, swap agreements and other derivatives,[9] would be enforced contractually, despite the absence of recognition by non-EEA authorities of resolution actions taken in the UK. Under the proposed transitional measures, the effective date of the rule would be phased in according to

[7] The PRA consultation paper on contractual stays in financial contracts is available at: http://www.bankofengland.co.uk/pra/Documents/publications/cp/2015/cp1915.pdf. Responses to the consultation are due by 26 August 2015.

[8] This issue is equally applicable to the temporary stays that may be imposed under the BRRD.

[9] You may also like to see our client note: "Bank Recovery & Resolution Directive: Implications for Repo and Derivative Counterparties," available here.

counterparty type so that it would apply to contracts with credit institutions and investment firms from 1 January 2016, asset managers and insurers from 1 July 2016 and all other counterparties from 1 January 2017.

The PRA's proposed rule builds on the ISDA 2014 Resolution Stay Protocol,[10] an industry initiative that was adhered to by 18 G-SIBS. The PRA's consultation paper refers to other jurisdictions making similar rules and the FSB contemplates broader adoption of contractual clauses by the end of 2015.

The US Perspective

The UK process for requiring financial institutions to address barriers to resolvability is in line with a major purpose of the resolution planning requirements set out by the Board of Governors of the Federal Reserve System (the "Board") and the Federal Deposit Insurance Commission (the "FDIC") under the Dodd-Frank Act in the US. Large financial institutions with operations in the US that are required to prepare annual resolution plans must identify obstacles to a rapid and orderly resolution of their US operations, come up with plans to remedy such obstacles and implement remediation plans. Failure by a financial institution to remedy material obstacles to resolvability may result in the US regulatory authorities finding the relevant financial institution's resolution plan not "credible."

If such a determination is jointly made by the Board and FDIC, the institution will have the opportunity to submit a revised plan detailing how it will address issues identified by the agencies and actions it will take to improve resolvability. US regulators have publicly released feedback with recommendations to address certain impediments to resolution, including, for example, recommendations that firms establish a less complex structure, develop a holding company to facilitate resolvability and demonstrate operational capabilities for resolution preparedness, such as the ability to produce reliable information in a timely manner.

If an institution fails to submit a revised plan or the plan fails to adequately remedy the deficiencies in the plan, the US regulators may impose increased capital and liquidity requirements, reduced leverage requirements and/or restrictions on growth and the type and scope of operations and activities on the financial institution. If those measures do not lead to the financial institution developing a credible resolution plan, then the US regulators could order the financial institution to divest certain assets or businesses.

[10] Available at: https://www2.isda.org/functional-areas/protocol-management/protocol/20.

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