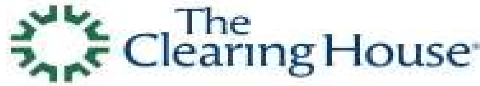

9 November 2011

By electronic submission to cp11_16@fsa.gov.uk

Alexander Brown
Recovery & Resolution Team
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25 The North Colonnade
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Re: Response to Consultation Paper 11/16 on Recovery and Resolution Plans

To the Financial Services Authority:

The Association for Financial Markets in Europe[1], the Securities Industry and Financial Markets Association[2] and The Clearing House Association[3] (collectively, the **Associations**), welcome the opportunity to respond to Consultation Paper 11/16 on Recovery and Resolution Plans published by the Financial Services Authority on 9 August 2011 ('**CP 11/16**').

[1] Association for Financial Markets (AFME) represents a broad array of European and global participants in the wholesale financial markets and its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. AFME, with offices in London and Brussels, is the European regional member of the Global Financial Markets Association (GFMA). For more information, visit www.afme.eu.

[2] The Securities Industry and Financial Markets Association (SIFMA) bring together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit www.sifma.org.

[3] Established in 1853, The Clearing House is the oldest banking association and payments company in the United States. It is owned by the world's largest commercial banks, which collectively employ over 2 million people and hold more than half of all US deposits. The Clearing House Association L.L.C. is a nonpartisan advocacy organization representing—through regulatory comment letters, amicus briefs and white papers—the interests of its owner banks on a variety of systemically important banking issues. Its affiliate, The Clearing House Payments Company L.L.C., provides payment, clearing, and settlement services to its member banks and other financial institutions, clearing almost $2 trillion daily and representing nearly half of the automated-clearing-house, funds-transfer, and check-image payments made in the US. *See* The Clearing House's web page at www.theclearinghouse.org.

Introduction

The Associations strongly agree that financial institutions need to be prepared to recover from situations of severe stress and that authorities need to have effective tools and information to enable the orderly resolution of financial institutions without needing to resort to taxpayer support, and therefore we support the FSA's goals in CP 11/16. The FSA's paper represents the latest in an emerging consensus on developing robust recovery and resolution planning and effective resolution regimes to avoid taxpayer-funded bailouts in the future. This consensus is represented in CP 11/16, in the Financial Stability Board's (**FSB**) Consultative Document on Effective Resolution of Systemically Important Financial Institutions, in the US regulators' rulemaking requiring resolution plans for certain financial companies and banks, and in the European Commission's crisis management proposals. We commend efforts to harmonise the requirements in these various proposals, and to avoid inefficient, duplicative and burdensome regulation.

While CP 11/16 is a significant step forward in achieving the goal of creating a credible alternative to taxpayer-funded bailouts, there remain a number of areas where we have recommendations and where additional clarification by the FSA would be helpful. We recognize that the FSA is required by primary legislation[4] to make recovery and resolution plans for UK-incorporated deposit takers, and in an effort to make the recovery and resolution planning process meaningful, has already undertaken a pilot program to create a model that is further developed through CP 11/16.

Considering the importance, novelty and complexity of creating an integrated and effective recovery and resolution planning process for both firms and regulators, a process which is likely to serve as a model for other EU member states, we respectfully suggest some modifications and refinements to the proposals aimed at more effective recovery and resolution planning. These are outlined in this Response below.

Single Plan Approach

We support the home country regulator leading the coordination of recovery and resolution planning, and the actual resolution of a firm, in all applicable jurisdictions. While we appreciate that the resolution of any particular parent or subsidiary will be governed by the insolvency regime in the jurisdiction in which that parent or subsidiary is established, we believe that for a complex, cross-border financial institution, coordination among resolution authorities in the various jurisdictions in which such firm operates in both the planning process and in the execution of a resolution, is essential. Therefore, we support the development of resolution plans that are led and coordinated by the home country regulator in coordination with members of the

[4] The Financial Services Act 2010.

institution's Crisis Management Group, in line with the recommendations of the FSB[5] and in CP 11/16.[6]

In particular, we suggest that the FSA organize simulations of the resolution of a hypothetical cross-border financial institution with foreign authorities to test amongst themselves how the FSA would participate in foreign proceedings, as well as how foreign regulators would participate in proceedings in the UK. We believe such testing exercises would allow regulators in the UK and abroad to try out their resolution procedures and amend those procedures before they are required to be implemented on an actual institution in an actual financial crisis.

Similarly, recovery planning should be the purview of the home country regulator, with the home country regulator coordinating with host country regulators. Otherwise, a financial institution could be subject to conflicting concerns and priorities in various jurisdictions, with no overall coordinating regulator. Moreover, recovery planning, even more so than resolution planning, cuts across legal entity and jurisdiction, and involves group-wide coordination and implementation. From their work together in the Crisis Management Groups, and agreement to broad principles as articulated by multi-jurisdictional bodies like the FSB, we expect that regulators will become increasingly comfortable with the judgments of their peers who are, for particular institutions based in their jurisdictions, in the best position to make a comprehensive assessment of the recovery plans.

Scope of the Recovery and Resolution Plans

We recognise that the FSA is required, by the Financial Services Act 2010, to make rules on recovery and resolution plans for UK-incorporated deposit takers and that the FSA has extended these rules to significant UK-incorporated investment firms.[7] We assume that this reflects the population of banks and investment firms that will be regulated by the Prudential Regulation Authority, to which responsibility for recovery and resolution plan rules will pass in early 2013.

We note that branches of non UK-incorporated firms will not fall within the scope of FINMAR 4, and hence will not be required to produce recovery and resolution plans, which we welcome.

Where a UK-incorporated firm which is a member of a non-UK headquartered group, falls within FINMAR 4.1.1R we are concerned that the scope of the information requirements and analysis in the rules is not focussed on the UK firm. For example,

[5] Financial Stability Board, Consultative Document on Effective Resolution of Systemically Important Financial Institutions (19 July 2011) at 32, Annex 1, paragraph 11.6.

[6] CP 11/16 at 5.21.

[7] CP11/16 at 1.16 – 1.19. The Financial Services Act 2010 requires the FSA to make rules on recovery and resolution plans for firms with a Part IV permission to carry on the regulated activity of accepting deposits (other than credit unions and insurers). The FSA has chosen to extend these rules, as the legislation provides, to UK-incorporated BIPRU 730k firms with assets exceeding £15 billion on their last accounting reference date.

under the Consultation Paper, the Financial Stability and Market Confidence Sourcebook (FINMAR) would state that 'A firm's (recovery and resolution plan) will need to take into account *the wider business of its group* (italics added)'.[8] Similarly, the resolution plan requirements are proposed to extend to significant entities, with a significant entity being defined under the rules as 'an entity within the group that the firm considers to be significant to the firm or to the group'.[9] In addition, the requirement to report interbank exposures must be completed on a consolidated basis for the entity for which the recovery and resolution plan is prepared and the companies in the same group.[10]

We request that the applicable provisions in FINMAR 4.1 be amended to clarify that for non-UK headquartered groups, the scope of the recovery and resolution plan will need to take into account the wider business of the group '*only where it is relevant and significant in the context the UK-regulated firm.*' Further, for both UK and non-UK headquartered groups, we propose that the definition of 'significant entity' should be limited to legal entities that are significant in the context of the resolution of the UK-incorporated firm. For a more detailed analysis of the scope of the rule requirements, please see our response to Question 1 in **Annex A**, and the analysis in **Appendix 1** thereto.

With respect to incoming EEA firms, which fall outside the scope of FINMAR 4, the powers of the FSA, as a host state competent authority, are limited by the single market directives, which reserve, inter alia, prudential regulation to the home state competent authority. We fully expect, however, that the EU's forthcoming legislative proposal on crisis management to provide a framework within which EEA competent authorities can coordinate in relation to the recovery and resolution of internationally active EEA firms and groups. We believe that the EU model is likely to provide a useful template for coordination between EEA competent authorities and third country regulators with regards to the preparation and supervision of RRPs for third-country firms (the UK branches of which will also fall out of the scope of FINMAR 4).

Cross-Border Cooperation and Coordination Agreements.

In accordance with the single plan approach, we support the home country regulator sharing the portion of the recovery and resolution plan relevant to a particular jurisdiction with such host country regulator. For that reason, we believe cross-border cooperation and coordination agreements, whether between regulators generally, or on a firm-specific basis, are especially important. While we support multi-lateral agreements as an ultimate goal, we believe it is appropriate to begin work on these agreements on a bilateral, home-host basis, particularly where the UK is the home country regulator or the largest host country regulator. We would welcome the

[8] Draft FINMAR 4.1.3G as another such examples, CP 11/16 states that the FSA expects firms to consider "how all significant members of the group (both regulated and unregulated) could be resolved" CP 11/16 at 1.20.

[9] Draft FINMAR 4.3.2R (Resolution Pack)

[10] CP 11/16 at 4.19.

opportunity to work with the FSA and the Bank of England to prepare a template for such firm-specific cooperation agreements.

Moreover, a critical part of such agreements should be restrictions on information sharing that are at least as stringent as the home country regulator's restrictions, so that a host country regulator is not in a position to share information more widely than the home country regulator would. We support the firms themselves, and private industry representatives, having access to, and input into, these cooperation and coordination agreements. Sharing the agreements will improve communication and cooperation between the firm and the members of the Crisis Management Group.

The interactions between home and host country regulators detailed above highlight the importance of international regulatory cooperation. We would, therefore, encourage the FSA to coordinate with their EU, US and other foreign counterparts, both in terms of developing a uniform approach to the recovery and resolution planning process, and in terms of establishing arrangements in advance of how they will cooperate and coordinate in the event of a cross-border resolution of a financial institution. This has been a key area of focus for the FSB, and we encourage national regulators to carry this forward to implementation.

Harmonising Informational Elements

Given the multitude of informational demands upon multi-jurisdictional, global financial services institutions, inefficiencies and overly burdensome regulation can only be avoided if informational requirements are aligned at the more granular levels for organizations that operate on a multinational basis. Many firms will have to change their internal reporting structures and invest heavily in information systems and personnel to produce the information that the FSA and other regulators will require. Creating different types of plans here and abroad will be a major project, and recovery and resolution planning should be structured so the process is efficient, and as consistent and uniform as possible.

As we noted at the outset, the FSA's proposals on recovery and resolution planning are being made as other regulators, including the US regulators, the FSB, and the European Commission, are promulgating regulations and making recommendations on recovery and resolution planning, as well. We strongly support efforts to harmonise requirements in various jurisdictions, and in particular reporting requirements, so as to avoid duplication, redundancy and inefficiencies. We recommend that the FSA coordinate with other regulators to undertake a gap analysis to review the information already being requested from firms and to determine what additional information is needed and for what purpose. In the alternative, if groups are required to produce local plan data in differing formats, UK firms should be able to provide data to FSA in the format produced for a non UK plan, where such data is required by the UK firm's plan.

Derivatives reporting, for example, is an area where we would like to see the reporting templates harmonised across jurisdictions and regulators so a single process can be used to generate the necessary information to satisfy multiple regulators in a manner that accurately reflects the institution's business. In addition, we strongly recommend that the information be produced and reviewed from a customer-oriented perspective.

We believe that in resolution the information about individual derivatives in isolation will be less relevant to the resolution authority than information that provides a view of the total customer relationship. For more detail on this issue, see our responses to Questions 4 and 5 in the attached **Annex A**.

Pending the development of a global template for derivatives reporting, non-UK headquartered groups should be permitted to submit data in the format required by their home regulator.

Cooperative Process

Finally, we would like to stress the need for dialogue, not just among regulators, but between regulators and institutions. We believe recovery and resolution planning should be viewed as a cooperative and iterative process, with the recovery and resolution plans evolving over time. We commend the FSA for taking an iterative and proportional approach to implementation.

In this spirit, we support putting into place transitional provisions for the next three or more years to allow compliance with the requirements and dialogue with the FSA and later the PRA. Such transitional provisions would recognise the obligations of firms to commence preparation of their recovery and resolution plans, and to engage with the authorities, but would ensure that no enforcement action would be taken against firms for having incomplete recovery and resolution plans during such transitional period.[11] Such a transitional period would allow the FSA and the Prudential Regulatory Authority to develop and refine their supervisory processes, as well.

In addition, we would appreciate further clarity as to the precise deadlines for the initial submission of each module. Specifically, we understand that Modules 1 through 4 are due by June 2012, and that Modules 5 and 6 would be due after the initial submission is reviewed and discussed with the FSA.[12] A staggered process is consistent with CP 11/16, which states that the initial review of recovery and resolution plans will be of Modules 1 to 4, and that following discussions with the FSA, firms will prepare the information for Modules 5 and 6.[13] Such a timetable would also provide firms and the FSA time to take account of any implications of the transition to the new framework for financial regulation in early 2013.

Resolvability Assessments

Finally, we respectfully suggest that measures to improve resolvability should be balanced against the need to manage the business as a going concern, and that steps to manage the institution for failure should not be taken at the expense of managing the institution for success. We support efforts to identify and address practical obstacles to

[11] BBA Response to FSA CP 11/16, p. 2.

[12] This is also implied by CP 11/16, which states that 'critical economic functions requiring a CFCA (Critical Function Contingency Analysis)) will be agreed in discussions between the firm and the authorities after the firm has prepared and submitted Module 4'.. CP 11/16, at 4.4 and 4.41.

[13] CP 11/16 at 5.11.

resolution, but urge that structural or other changes should be evaluated in light of the impact on going concern priorities, such as maximizing value for shareholders. The imperatives of operating the firm in a safe and sound manner, encouraging recoverability, and enhancing resolvability (if separate) should have due regard for each other.

The stated objective of Critical Function Contingency Analysis (CFCA) is to enable authorities to 'unplug' critical economic functions over a resolution weekend.[14] We believe that in many resolution scenarios, it may not be appropriate for resolution authorities to 'unplug' certain functions over the weekend. For example, it may be possible to achieve a better outcome if a bail-in tool is employed to stabilize the firm and buy time for controlled separation / wind-down of certain functions at a later date. We recognise the need to produce CFCAs for all critical economic functions, with a view to how they could be separated and / or wound down in an orderly manner, but we do not believe that ex ante attempts to ensure weekend severability for all critical economic functions would necessarily support the objectives of effective resolution.

In the future, when the FSA and later the Prudential Regulation Authority makes its assessments regarding a firm's resolvability, in order to ensure transparency, we suggest that the standards for making resolvability assessments should be clear. Also, as we acknowledged at the outset, while we recognize the authority of the FSA over entities incorporated in the UK, we urge the FSA and later the Prudential Regulatory Authority to consult and coordinate with home country regulators in making such assessments, including through the Crisis Management Groups. We believe that the ultimate assessments of top-level and group-level resolvability should lie with the home country regulators.

We also note that such assessments are highly interconnected with the other initiatives urged here, such as progress on cross-border coordination and cooperation agreements. Therefore, we do not think that impediments to resolvability beyond those within an institution's power to control should be used as a justification for ordering institutions to change their business structure or practices. Instead, such impediments should be addressed in a timely way by the FSA and other national supervisors and resolution authorities and the results reflected in the iterative process of recovery and resolution planning.

[14] CP 11/16 at 4.20, 4.21.

* * *

The Associations thank the FSA for the opportunity to respond to CP 11/16. If you have any questions, please do not hesitate to e-mail or call the undersigned.

Sincerely,

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ANNEX A

afme/ Finance for Europe

Association for Financial Markets in Europe

Consultation Response
09 November 2011
Response to Questions in Consultation Paper 11/16 on Recovery and Resolution Plans

Questions

Question 1: Does the detailed guide to the preparation of RRPs, set out in the RRP guide, give adequate instruction and assistance to prepare an RRP? Are there areas which require further explanation?

There is ambiguity surrounding the scope of which exact legal entities in the group must meet the resolution plan information requirements as between group companies that are **'significant'** in the context of the **resolution of the firm**, and those that are **'significant'** in the **context of the group as a whole.** This distinction is particularly relevant to non-UK headquartered groups where there could be numerous entities that are significant within the larger group but insignificant to the resolution of the UK authorised firm. Accordingly, only entities significant to the resolution of the UK authorised firm should be included. We have set out a more detailed analysis of the scope of Financial Services Act 2010, FINMAR 4.3.2R and Modules 3, 4 and 5 in **Appendix 1** hereto.

Our comments regarding recovery plan requirements for non-UK headquartered groups are set forth in our letter.

Question 2: Please give your views on the Recovery Plan proposals for:

- **governance;**
- **key Recovery Plan Options; and**
- **assessment criteria.**

We generally support the recovery plan proposals (subject to our comments regarding non-UK headquartered groups). Regarding governance, we would caution against the unintentional creation of new statutory legal duties on directors that could unduly constrain them in circumstances in which they need to be able to take unfettered action as quickly as possible.

Question 3: Please give your views on the proposals for the Recovery Plan trigger framework.

- It should be acknowledged that where a recovery plan employs quantitative triggers (i.e. use of Capital Planning Buffer), they should be the catalyst for senior crisis management team to meet and determine what action needs to be taken depending on the specific issue at hand and the prognosis. This should range from nothing - as they see the stress is only temporary - to the invocation of the recovery plan, and everything in between. Triggers should not by themselves unleash a set of pre-

determined recovery actions. Some triggers may also involve a degree of judgment in themselves and therefore should allow for management discretion in determining whether the conditions giving rise to the trigger have indeed occurred.

- We think it is important to understand the interaction between the triggers on the Proactive Intervention Framework (PIF), and the firm's recovery triggers which will need to be set at an earlier stage. We would expect regulators to engage in an iterative discussion with firms to ensure the appropriate calibration of such triggers.

Question 4: Do you agree it is appropriate for the FSA/PRA to collect interbank exposure data as outlined? What changes, if any, would you suggest to the data template?

We have a number of concerns with the interbank exposure data.

- It is simply not feasible for firms to provide interbank exposure data for a period that commenced prior to the publication of the Consultation Paper. There is also still a fair amount of uncertainty on exactly what is required, notwithstanding the several industry meetings held by the Bank of England (which have not been attended by all firms). Requiring firms to provide this complex and essential data in this context is simply not advisable and is likely to set a precedent for sub-optimal reporting going forward in the UK and for other EU Member States following suit in the adoption of their data rules.

- We strongly believe that the specific requirements and format should be absolutely aligned with the US and globally such that there is one single template and in order to facilitate a consistent approach to resolution globally. This data should also, notwithstanding its use for resolution, be aligned with the development of the FSB macro prudential tools and frameworks that are currently being developed to enable authorities to identify, monitor and take action to remove or reduce systemic risks.[14] Given the criticality of this data to effective cross-border resolution, we urge the FSA to work with its counterparts, the FSB and the industry to develop a state of the art data framework that can be efficiently produced by firms and used by authorities for both micro and macro prudential purposes.

  More work needs to be done on this template internationally to accommodate different firms' operating and funding models and relative global or regional systemic risk.

Question 5: Please give your views on the suggested information requirements for both derivatives and securities financing, the ability of firms to produce the information quickly (recognising that some modifications to systems may be

[14] Financial Stability Board, *Understanding Financial Linkages: A Common Data Template for Global Systemically Important Banks*, Consultation Paper, 6 October 2011.

needed) and comments on whether it would be possible to achieve the same ends through alternative means.

- **Specifically, we welcome feedback regarding the appropriateness of individual data fields. To what degree is there variation in the documentation in place, particularly for exchange traded trades? Are there other pieces of data that firms consider would be of use to understand the derivatives or securities financing position?**
- **We would also welcome feedback on the proposed frequency of derivatives data collection, and feasibility (and preferred method) of delivering potentially large quantities of data, including the possibility of the authorities collecting data 'on-site' ahead of resolution. Please detail where there may be fields where data would need to be provided separately to the main data tape, for example, in a different format.**
- **We invite feedback on the suggested information requirements for both derivatives and securities financing, the ability of firms to produce the information quickly (recognising that some modifications to systems may be needed) and comments on whether it would be possible to achieve the same ends through alternative means.**

Like the interbank exposures table, the derivatives template should also be aligned with the US and globally as well as be capable of being fed into the FSB macro prudential data framework being developed. We believe the challenge and delay this may present is justified by the lessons learned from Lehman regarding the importance of producible and comprehensible trading position and counterparty information to resolution.

Aside from the need for a single global format, we suggest the derivatives template would be more useful to facilitating the selection of the most appropriate resolution tool if it were more customer-based approach instead of product-based. We agree with the comments by the BBA on this issue (reproduced at **Appendix 2** hereto).

Question 6: Please give your views on the list of economic functions. For example, have we failed to identify any important economic functions?

We believe economic functions will differ materially firm to firm due to firms' different operational and funding model**s.** We agree with the BBA response that it may be beneficial to overlay a counterparty focus onto the economic function analysis in order to more quickly identify which resolution tool is appropriate in a crisis situation.

Type of customer activity	***Resolution approach***
Retail / SME portfolios	Managed portfolio
Corporates	Customer relationship
Trading activity	Counterparty rating
Payments	Continuity of service

Question 7: Please give your views on the proposals for the provision of information and analysis on:

- **group structure and legal entities;**
- **economic functions; and**
- **barriers to resolution.**

We recognise CFCAs that allow critical economic functions to be either separated or wound down following resolution must be completed on an *ex ante* basis. However, we are concerned that the FSA's approach to resolution may over rely on the ability to 'unplug' critical functions over a resolution weekend.

A limited number of resolution scenarios may require the separability of economic functions over a weekend. However, we are not convinced that (a) the importance of this approach should necessarily be emphasised over other resolution tools, or (b) it is appropriate to plan to separate certain economic functions (e.g., the trading book) over a short time period.

We believe the FSA should focus on ensuring it has the information and analysis required to deploy the tools that will lead to an effective resolution. Attempting to unplug or separate highly complex and interconnected functions during a crisis will be highly operationally challenging, increase the risk of a dramatic loss in value and introduce the need to deal with multiple parties. In some circumstances, it may be more appropriate to maintain the integrity of a firm in the short-term (e.g., through the use of bail-in or other appropriate tools) with any separation activities happening over the medium-term. We question the value of producing the information and analysis required to allow certain economic functions to be separated over a resolution weekend where this action is unlikely to support an effective resolution. In such circumstances a more valuable analysis would be one aimed at proving deep resolvability utilising the most suitable resolution tool.

Differing business models will drive different resolution strategies. We recognise that CFCAs have an important role to play in resolution but do not believe that *ex ante* attempts to ensure weekend severability for all critical economic functions would necessarily support the objectives of effective resolution.

Question 8: Do you support the proposal to assign responsibility for RRPs to an executive director of the firm?

Yes.

Question 9: Do you agree with the above approach for the preparation of RRPs for internationally active firms?

See our comments in our Letter and in response to Question 1 above.

Question 10: Do you agree with our stated policy objective, which is to promote the speedier return of client money and assets?

We strongly endorse the FSA's objective of promoting the speedier return of client money and assets.

Question 11: Do you agree that we should establish a CASS RP to help achieve this objective, and to contribute toward better outcomes in general?

We agree that CASS RP should help to achieve the objective of more timely returns of clients' assets and money and well as contribute toward better outcomes.

Question 12: Do you have any comments on the proposed policy, as set out above, and in Annex 4 of the CP/DP?

AFME members generally support the FSA's proposals for documentation as set out in Annex 4, with the following comments:

Section 1 – Item 2

The FSA propose that a document be maintained that shows the firm's management and a list of individuals who are significantly involved in the Client Money and Assets ('CMA') processes. As the FSA are aware, many AFME members are large international groups who have global operations. Accordingly, the number of staff, on a global basis, who work in their Operations/Settlement/Custodian departments will number hundreds, if not thousands of staff. Most of these staff will have the ability to significantly impact CMA processes, in that they will, as part of their individual functions, have the ability to transfer CMA.

Given that firms are required to effect changes to their Recovery documentation within five days of the relevant change and given the degree of staff turnover, firms will be faced with a constant updating challenge. Accordingly, we suggest that firms be required to maintain a list of only senior directors and senior managers who have responsibility for CMA processes.

Section 1 – Item 3

The FSA propose that a document be maintained of a corporate structure chart of a firm's group including all legal entities and all of the branches of each legal entity. We see little benefit in providing details of all branches of each legal entity, particularly in cases where a legal entity has hundreds, if not thousands of branches. Accordingly, we suggest that only lists of EEA branches be maintained.

Other Issues

What relevance for CMA purposes is a list of clients' MIFID categorisation, which is already an existing requirement?

Question 13: Do you agree that the CASS RP will contribute to promoting the speedier return of client money and assets?

Yes.

Discussion Paper Questions

Questions 14 to 18 raise significant issues that require further work. We have agreed with the BBA that the industry shall conduct more in depth analysis with AFME leading on the trading book and clearing and settlement issues and the BBA leading on the critical economic functions/service agreements, the capitalisation of these services and continuity.

Question 14: Should firms be required to take steps to ensure that services to UK entities containing critical economic functions are covered by effective, insolvency robust service agreements?

Question 15: Should the companies which provide such services be required to be capitalised adequately so that they can resist collapse in circumstances of group-wide failure?Question 16: What other steps should be taken to help ensure the continuity of critical banking services?

Question 17: What are the changes to payments, clearing and settlement mechanisms that would allow banks to be more resolvable and would ensure continuity in the provision of vital payment, clearing and settlement functions?

Question 18: Matters on which we would particularly appreciate views or comments on are:

- **alternative approaches to resolving large trading books;**
- **alternative approaches to the valuation and realisation of collateral which mitigate market instability in the event of an entity with a trading book being placed into an insolvency procedure;**
- **changes in regulatory or contractual working practices which could make unwinding trading books speedier and less costly (e.g. default rules applied under the ISDA Master Agreement); and**
- **financing of trading book wind-downs.**

However, the above list is not in any way restrictive and we will value all constructive views on improving the outcome of the resolution of trading books.

Question 19: Bail-in:

- **Do you believe that bail-in could be an effective tool in helping to recapitalise a firm that is either at the point of or is failing, in order to avoid a public injection of funds?**
- **What are the pros and cons of using the various tools: private sector contingent capital, contractual resolution bail-in and statutory resolution bail-in?**
- **Are the various tools best used separately or in tandem?**
- **Do you think it will be necessary to regulate the quantum and the maturity profile of bail-in-able instruments if use of the resolution bail-in tools is to be successful?**

- **Do you see any alternatives to provision of liquidity assistance to a recently bailed-in firm by the public sector?**
- **Do you think that, as a result of the bail-in arrangements, the cost of capital for banks will increase, or decrease, in a material way? And, what will be the effect on the capital structure?**

We strongly support including recapitalization of a firm or its operations – i.e., bail-in – as a resolution tool, provided that resolution proceedings are only commenced as a last resort after the failure of all other measures reasonably designed to prevent a particular firm from becoming nonviable.

Indeed, we believe that resolving firms either by recapitalizing them directly by an exchange of claims for equity in the firm, or transferring their systemically important and other viable operations to a bridge institution and exchanging claims against the SIFI for equity in the bridge,[15] should be available and used if that resolution technique would maximize the value of the firm for the benefit of its creditors and minimize the systemic consequences of the firm's failure. Assuming appropriate safeguards for creditors are in place, we believe that recapitalizations are likely to be a more effective resolution tool during a financial panic than a fire-sale liquidation of financial assets.

It is critical that a broad global consensus is reached on the scope of bail-in powers. Aligning resolution regimes and the scope for bail-in within resolution reduces the risk of regulatory arbitrage and any potential differential perceptions of the market impact of bail-in. We support the FSB's suggestion for 'key principles' as a means of delivering broadly consistent bail-in regimes across the world's key financial centres.

Bail in within resolution (like most resolution tools) for cross border firms will also be afforded a greater chance of success if *ex ante* agreement can be reached on home / host issues - both in the design phase and post implementation. We suggest that CMGs could regularly test the role that bail-in might play in their 'war-gaming' of firms' RRPs.

[15] *See, e.g.*, GFMA Response to FSB Consultation on Key Attributes of Effective Resolution Regimes for Financial Institutions (Sept 2011), ***available at*** http://www.gfma.org/pdf/GFMA-Joint-Trade-FSB-SIFI-Resolution-Response.pdf; AFME, Response to the EU Commission Consultation on Technical Details of a Possible EU Framework for Bank Recover and Resolution (Mar 2011), *available at* http://afme.eu/Documents/Consultation-Responses.aspx; AFME, Discussion Paper, SYSTEMIC SAFETY NET: PULLING FAILING FIRMS BACK FROM THE EDGE (Aug 2010), *available at* http://afme.eu/Divisions/Prudential-Regulation.aspx; Comment Letter from SIFMA and The Clearing House to the FDIC on the FDIC's Second Notice of Proposed Rulemaking under Title II of the Dodd-Frank Act: Recapitalizations as an Effective Way to Resolve Systemically Important Banks and Non-Bank Financial Companies on a Closed Basis Without Taxpayer-Funded Bailouts (May 23, 2011), *available at* http://www.fdic.gov/regulations/laws/federal/2011/11c16Ad73.PDF; INSTITUTE OF INT'L FIN., ADDRESSING PRIORITY ISSUES IN CROSS-BORDER RESOLUTION 19-25 (May 2011), *available at* http://www.iif.com/regulatory/resolution.

The recapitalisations should be effected by starting at the bottom and moving up the capital stack, i.e., in reverse order of priority. Thus, for example, senior common equity would be converted to ordinary common equity first, followed by preferred equity, followed by hybrid regulatory capital instruments, followed by subordinated debt, and followed by other debt obligations that rank below senior debt. Only as a last resort, where the conversion of junior instruments to common equity is insufficient to recapitalize the firm or the portion of its business transferred to a bridge at a reasonable level, should any of the senior debt be converted to common equity. Moreover, only that portion of the senior debt that is necessary to recapitalize the firm or the bridge at a reasonable level should be converted.

We believe that bail-in within resolution should apply, once adopted, to both pre-existing and subsequently issued debt instruments for several reasons.

- First, this will almost certainly make the holders of pre-existing debt instruments better off because the normal recovery on such instruments in resolution or other insolvency proceedings is the liquidation value of the failed bank's assets, which is almost certain to be lower than the value of the equity in the recapitalized bank, which will represent a pro rata share of the going concern value of the recapitalized bank.

- Second, it will increase the likelihood that there will be enough debt to recapitalize the failed bank at a viable level, which for the reasons stated above is likely to increase the recovery of the holders of both pre-existing debt and subsequently issued debt.

- Third, it will avoid confusion in the market as to which instruments are within in its scope and unnecessary speculation as to whether a particular debt instrument was issued prior to or after the adoption of bal-in within resolution – in that particular jurisdiction.

- Fourth, it will avoid unintentionally altering a firm's capital structure by rendering existing instruments effectively senior to new 'bail-in-able' instruments.

- Fifth, the adoption of bail-in within resolution will be more likely to foster market stability, particularly if coupled with a clear communication strategy by each jurisdiction that explains how bail-in will operate.

- Finally, it will increase the likelihood that banks will satisfy the Basel III requirements regarding loss absorbency that will take effect in 2013.

Resolving firms by recapitalizing them directly or using a bridge to recapitalize the systemically important and other viable parts of their businesses should both reduce the incentive of creditors to run at the first sign of trouble, and ensure that any and all losses are ultimately borne by shareholders and creditors rather than taxpayers. In the absence of taxpayer-funded bailouts, which the Associations oppose, the destabilisation created by fire-sale liquidations poses profound financial market and macroeconomic risks. It is thus vital that resolution regimes not only allow for orderly resolutions, but

also for recapitalisations in ways that the market can readily anticipate, clearly plan for, and count on to prevent panicked asset liquidations.

Scope of Application

- Section 139B (1) of the Financial Services and Markets Act 2000 (FSMA), inserted by section 7(1) of the Financial Services Act 2010, requires the FSA 'to make rules requiring each authorised person (or each authorised person of a specific description) to prepare, and keep up-to-date, a recovery plan'.
- Section 139B(8) of FSMA provides that: 'The authorised persons subject to general rules about recovery plans must include authorised persons in relation to whom any power under Part 1 of the Banking Act 2009 [special resolution regime] is exercisable'.
- Hence, the FSA is under a statutory duty to make RRP rules that apply to all UK-incorporated and authorised 'deposit-takers' (as defined in the Banking Act 2009). However, the FSA has flexibility in respect of whether to make RRP rules in that apply to investment firms and branches of third-country firms.
- We welcome, therefore, the statement in paragraph 1.21 of the CP that the FSA will not be 'requiring RRPs from UK branches of overseas entities'. We also welcome the approach outlined in paragraph 5.16 of the CP: namely that a group's Home State regulator should require and be responsible for a group-wide recovery plan.
- We assume, therefore, that where an EU or third-country group has a UK-incorporated and authorised deposit-taker, the FSA will engage with the group's home state regulator to obtain, inter alia, the sections of the group recovery plan that are relevant to the UK.

Given the desirability of facilitating international approaches to the recovery of globally active groups (and, in time, their resolution), the FSA and HM Treasury should take the opportunity afforded by the Financial Services Bill to consider whether there is scope for 'switching off' the requirements in section 139B of FSMA where the FSA considers that a group's RRP has been prepared under equivalent legislation and is able to obtain the necessary information from the group's home state regulator.

FINMAR 4.3.2R Definition of 'Significant Entity'

- Proposed rule FINMAR 4.3.2R defines **'significant entity'** as a group entity that 'the firm considers to be significant to the firm or to the group'. For a non UK-headquartered firm, this would mean all group companies that are significant in the context of the group as a whole even if they have no relevance to the resolution of the UK trigger firm. For firms within wider non-financial groups, it would encompass parts of the group that are not subject to consolidated supervision. We would propose that FINMAR 4.3.2R should be limited to group entities ***that are significant in the context of the resolution of the UK regulated firm.*** This would be consistent with the statement in the comments on module 3 of the RRP guidance pack to the effect that the FSA expects the firm to address only entities that have a material bearing on the UK firm in question.

- On a more detailed level, in proposed rule FINMAR 4.3.5R(1), sub-paragraph (c) and paragraph (2) refer to 'significant entities' but the introductory wording to paragraph

(1) refers to '*group* members', sub-paragraph (a) refers to 'significant *group* entities' and sub-paragraph (b) refers to '*group* entities'. In addition, paragraphs (3) and (4) require information about 'any other UK members of the *firms' group*' and sub-paragraph (4) refers to information about 'any entity within the *group*'. We suggest that these provisions should all be limited to references to the firm and significant entities as defined in FINMAR 4.3.2R (or, in the case of paragraphs (3) and (4), to other significant entities that are incorporated in the UK).

- In addition, FINMAR 4.3.5R(2) should make clear that it is limited to the UK economic functions, in line with Module 4 of the guidance pack, e.g. by amending the definition of 'economic function' to specify that it refers to activities, services or functions performed or provided 'in the UK' by a legal entity.

Detailed comments to Modules 3, 4 and 5

In order to make the proposed rules and the RRP guidance pack consistent, we suggest the following comments to Modules 3, 4 and 5:

Module 3:

In the 'key elements' section:

- the term 'significant entities' should replace the term 'Significant legal entities' which is used in a number of places (this should be reflected throughout the grid that describes module 3) to make clear that the requirements are aligned with the rules;
- in the fourth bullet point, the term "significant entities" should replace 'legal entities' (otherwise the pack appears to require an analysis of financial dependencies between every group company);
- in the seventh bullet point, the references to 'significant UK legal entities' and 'any non-UK legal entities' should be replaced by references to 'UK significant entities' and 'non-UK significant entities' (the same change should be made to sections 3.8 and 3.9);
- Section 3.1.1 (Group structure): the data required should clearly relate to 'significant entities' (e.g. the relative size and total number of significant entities).
- Section 3.2 (Capital and funding): It should be made clear that section 3.2 requires information only on significant entities (in the same way as section 3.1.2).
- Section 3.5 (Booking practices): It should be made clear that section 3.5 relates to the booking practices of the UK regulated firm to which the RRP requirements apply (or UK regulated firms that are significant entities) and require disclosure of transactions with other significant entities (otherwise they would require disclosure of any transactions even with immaterial entities), although we note that the requirements are currently limited to transactions with unregulated entities only. Some of the data required appear to be specific to US groups e.g. the last field which refers to capital held at the group level in the US.

- Section 3.6 (Interbank exposures). The text of the module states that it requires information on 'the firm's' 20 largest interbank exposures, suggesting that it is limited to the UK regulated firm to which the requirements apply. However, paragraph 4.19 of the consultation paper suggests that the data should be prepared on a consolidated basis for the regulated firm 'and the companies in the same group' (which could encompass a wider set of entities, including entities outside the scope of consolidated supervision). The requirement should be limited to the regulated firm or, at most, to the consolidated (or sub-consolidated) group (or sub-group) for which the FSA is the consolidated supervisor.

- Section 3.7 (Derivatives): It should be made clear that this section refers to the positions and data relevant to the UK regulated firm to which the requirements apply.

Modules 4 & 5:

- It should be made clear to which legal entities the requirements relate, in a way which is consistent with the rules. For example, the purpose statements refer to the (critical) economic functions operated by 'the firm'. However, the 'key elements' sections indicate that the economic function might sit in other legal entities (last bullet point). As discussed above, the focus should be on the UK economic functions of the firm and other significant entities incorporated in the UK. It would be disproportionate to require an economic function analysis on every UK legal entity (e.g. legal entities that might not even be in the UK consolidated group or carrying on financial activities). In addition, it would be inconsistent for these modules to require consideration of a wider group of legal entities than addressed by module 3.

APPENDIX 2

The Resolution of Derivatives Books in Banks (BBA paper)

Over the last few months, we have seen the approach that the FSA and Bank of England appear to be taking that Derivatives and SFTs, often classified as the Trading Book, is a distinct line of business that can be considered as a distinct economic function and resolved in isolation. We believe that this is a misunderstanding of the role of such activities in many banks which could lead to a sub-optimal resolution process and which needs to be addressed.

1. *The role of Derivatives in Commercial Banks*

A medium to large Commercial Bank has a book of derivatives and similar assets for a number of commercial reasons:

The Bank wants to offer derivatives its commercial and institutional customers to meet their risk management requirements.
The Bank needs to manage the risks created in its underlying portfolios, often through a central function. These risks include specific hedging for single risks and macro hedging for wider positions such as forex, interest rate and credit. The role of such hedging is both acknowledged and encouraged by the Basel 3 framework.
Banks also provide market-making in specific derivatives products or businesses, ensuring that there is a liquid and fairly priced market when underlying risks need to be hedged.
Certain banks may also take proprietary positions which are in excess of actual or anticipated requirements for either clients or the banks themselves.
It is not possible to distinguish between these activities within any derivative book.

2. *Current Approach of FSA and B of E*

The FSA and B of E currently propose that the derivatives are differentiated into 'Good' and 'Bad' based upon whether the end of day mark-to-market is receivable from or payable to a counterpart (are they in or out of the money), taking into account netting agreements but also considering some undefined judgmental factors (which we believe may be contagion risks to the domestic economy, etc). After this segregation, In-the-Money positions representing unrealised profits from asset revaluation provisions would be transferred to the Good Bank and Out-of-the-Money positions showing unrealised losses (or liability revaluation provisions) would go to the Bad Bank.
The implications are that banks would need to be able to segregate the Good trades from the Bad trades into two separate / partitioned systems, albeit that the Bad trades will require less active management. This would enable the Good and Bad banks to separately manage payments, settlements, processing, liquidity, funding and risk positions. All customers would need to be of their status (Good Bank or Bad Bank) before the opening of business so that it is clear if they are carrying on business as usual with a Resolution Authority managed Bridge Good Bank or business as a creditor of / debtor of the Bank in Administration (BinA) and hence their exposures are frozen. This effectively means between 7 am on a Saturday morning (after the completion of the off-

line run and revaluations) and 7 pm on Sunday evening before the markets open in Asia on Monday morning.

3. *Issues with this Approach*

There are three major issues with this approach:

It makes no assumption regarding the credit worthiness of a counterparty.
It does not take into account non-derivative elements of a relationship which are not connected via netting agreements. This might include corporate loans which become unaffordable if the company will no longer receive payments from the Bank on its Out-of-the-Money contracts.
It takes no account of the CVA provisions The danger is that this will create new open risk positions in the Good Bank and open risk positions for counterparts transferred into a Bad Bank. Both of these events could have destabilising effects upon the market and 'credit-worthy customers' who are now customers of, in some cases, both the Good and Bad banks. This will be exacerbated if Bad Bank customers do not have the relationships or cannot find counterparties willing to hedge the now-open risk positions. Replacing these will also cost money, forcing losses onto otherwise creditworthy customers and a consequence may be greater customer driven-netting arrangements against non-derivative arrangements which would bind these elements together.

4. *Consequences for segregating Good vs. Bad Bank*

The consequence of recognising that derivative transactions cannot be seen in isolation but are part of a wider relationship with a customer or counterparty is that the segregation of assets and liabilities needs to be more customer driven. It is essentially the creation of a viable banking businesses, taking into account all of the elements of the relationship where the overall revenues and risks are considered, leading to segregation based upon:

Good Bank containing all of the business (exposures, products and services) conducted 'Good Customers'
Bad Bank contains all of the business (exposures, products and services) conducted 'Bad Customers'

This then leads to a logically structured approach to decide where the line in the sand is between Good and Bad customers. This approach must not be confused with Good Bank equals 'no risk' a Bad Bank equals 'risk'. It is an assessment based upon Good Bank is viable with customers that are deemed to capable to continuing to perform

The sense of this approach is that one should find that the number of the Bad Customers are likely to be a small % of the total portfolio, but material in exposures. A consequence of this is the need for the bank to provide a tool for the segregation would be akin to the Single Customer View for retail customers.