HM TREASURY

Financial sector resolution:

broadening the regime

Cm 8419

August 2012

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broadening the regime

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1 Introduction

Background

1.1 The 2007-09 financial crisis exposed a great many flaws in the global financial system. In particular, systemically important banks, when they ran into trouble, could not be allowed to collapse in a disorderly way, because of the damage this would have done to the financial system and the wider economy. With no alternatives, the taxpayer was forced to step in and bail-out failing banks.

1.2 To address these problems, a wide-ranging programme of banking and wider financial sector reform is underway at European and global level. The UK is actively engaged in this and is also taking action domestically. When it came into office, the Government asked the Independent Commission on Banking to recommend ways to strengthen the resilience of the banking system and promote competition. In June, the Government published a white paper setting out how it would implement those recommendations.[1] The UK also already has in place a special resolution regime (SRR) for banks, as well as enhanced capital and liquidity regimes. Collectively, these reforms seek to ensure that banks are better able to cope with shocks in the future and that, if banks do fail, they can be resolved safely without risk to the taxpayer or to financial stability.

1.3 But banks are only part of the financial system. Other types of financial institutions can also pose a risk to financial stability, if there is no way for them to fail safely. The disorderly failure of financial market infrastructures (FMIs) – systems that connect market participants to each other – could also severely disrupt both financial markets and the normal functioning of the wider economy.

1.4 The potential economic cost of allowing systemically important non-bank financial institutions or FMIs to collapse means that they too may need taxpayer support should they run into trouble, if there is no way for them to fail safely. For example, in the recent crisis, the US authorities provided taxpayer-funded support to bail out Bear Stearns (an investment firm), AIG (an insurer) and also to underpin money market funds.

1.5 Because of these risks, in its banking reform white paper, the Government undertook to explore the case for addressing gaps in the resolution regime framework for non-banks on a more accelerated timetable than that currently envisaged in ongoing international work.

1.6 In this paper, the Government now sets out proposals and questions for consultation on enhancing the mechanisms available for dealing with the failure of systemically important non-banks. This consultation covers four broad groups, as follows:

- investment firms and parent undertakings;
- central counterparties (CCPs);
- non-CCP financial market infrastructures (non-CCP FMIs); and
- insurers.

[1] HM Treasury and Department for Business, Innovation & Skills, 2012, *Banking reform: delivering stability and supporting a sustainable economy*: http://www.hm-treasury.gov.uk/d/whitepaper_banking_reform_140512.pdf

1.7 Investment firms can clearly be systemically important, as evidenced by the disruption to financial markets in the aftermath of the collapse of Lehman Brothers in September 2008. And in some circumstances, resolution authorities are likely to need powers over parent undertakings to deal with a failing bank or investment firm.

1.8 CCPs similarly have an obvious potential to be systemic. The disorderly failure of all or part of the critical clearing services provided by a CCP could result in severe disruption to financial markets, particularly as there are often very few CCPs (sometimes just one) that clear particular products.

1.9 Non-CCP FMIs include payment systems and securities settlement systems. Many of those are likely to be systemically important. For example, the failure of the UK payments system would leave firms and individuals unable to transfer money electronically, with the potential for a catastrophic impact on financial markets and on wider economic activity.

1.10 The case for insurers is less clear cut. The failure of an insurer may not trigger financial instability due to the cessation of its core insurance activities (although this would depend on its market share for critical products). But inter-linkages with other financial institutions may pose a threat.

1.11 For these reasons, the Government considers that these four types of non-bank are most likely to have the potential to be systemically important – recognising that, in each case, it is likely that only some, if any, of each type will actually be so. However, the Government does not preclude the possibility of other types of non-bank – for example, hedge funds, or non-bank finance companies – being systemic. The Government would therefore welcome evidence, analysis and views on the extent to which other types of non-bank may be of systemic importance.

1.12 In taking forward the proposals in this consultation document, an important consideration will be how clearly systemic a non-bank is. Where institutions are systemic, the Government will also consider – and is looking for views on – the most appropriate type of policy response. In some cases, extending and/or strengthening existing administration/run-off arrangements may be sufficient, as opposed to introducing a new, comprehensive resolution regime.

1.13 The Government will also bear in mind that while some services may be best supplied by a single provider, in many other areas competition is essential. This is not only because it reinforces the European Single Market and so drives economic growth, but also because it potentially mitigates systemic risk and facilitates the resolution of failing institutions by ensuring substitutability between providers. The resilience of the financial system is strongly supported by measures to promote competition and tackle abusive dominant market practices, for example with respect to clearing services.

1.14 Overall, a balance needs to be struck between enhancing financial stability, and ensuring that the regulatory regime is not unnecessarily complex or burdensome (for both the authorities and industry).

1.15 The Government will pay close attention to developments in Europe and also to other international work, so that UK action to ensure that non-banks can fail safely both supports the strengthening of the Single Market, and adequately reflects the cross-border nature of financial markets.

1.16 The draft Recovery and Resolution Directive (RRD) published by the European Commission in June proposes resolution regimes for investment firms and financial holding companies, as well as banks. This is highly complex legislation and it is uncertain when it will be adopted in Europe. In addition, the European Commission is also planning to publish a consultation paper on resolving failing non-banks later this year.

1.17 Internationally, the Financial Stability Board's (FSB) 'Key Attributes for Effective Resolution Regimes'[2] – endorsed by the G20 – require that resolution regimes are put in place for all systemically important financial institutions (banks and non-banks) and for FMIs. In addition, the FSB is also currently taking forward a number of workstreams on strengthening the oversight and regulation of the shadow banking system, on which it is due to report later this year.

1.18 Other international bodies, including the Committee on Payment and Settlement Systems and the International Organization of Securities Commissions (CPSS-IOSCO), and the International Association of Insurance Supervisors (IAIS), are also working on these issues. In particular, CPSS-IOSCO is expected to publish recommendations on the resolution of FMIs around the date of this consultation document. This international work will be taken into account when finalising these proposals.

1.19 And in the US, the Dodd-Frank Act allows the scope of the authorities' stabilisation powers to be extended to any financial institution if – among other things – its failure under insolvency law would have a serious adverse impact on financial stability.

1.20 For clarity, in this document, 'resolution' refers to the use by the authorities of stabilisation powers (such as the transfer of all or part of a firm's property or business to a private sector purchaser, or to a 'bridge entity' controlled by the authorities). 'Insolvency' refers to a firm entering a liquidation or (possibly modified) administration process (such as the Special Administration Regime for investment firms introduced under the Banking Act 2009).

1.21 This consultation document includes indicative draft legislative clauses for certain key aspects of the envisaged resolution regimes for investment firms, the parent undertakings of investment firms and deposit-taking institutions, and central counterparties. Unless the context requires otherwise, references in these draft clauses to a 'section' are to that section of the Banking Act 2009. A full suite of indicative draft clauses will be published on HM Treasury's website early during the consultation period. The draft clauses are, of course, subject to change. They have been included at this stage to help inform comment on the detail of the Government's proposals.

How to respond

1.22 The Government seeks views on the proposals and questions set out in this consultation document. Responses are requested by 24 September, 2012. The Government cannot guarantee that responses received after that date will be considered.

1.23 This paper is available electronically at: www.hm-treasury.gov.uk. You may make copies of this document without seeking permission. Printed copies of this document can be ordered on request from the address below.

1.24 Responses can be sent by email to: non-bank.resolution@hmtreasury.gsi.gov.uk. Alternatively they can be posted to:

Financial Stability – Contingency Planning Team

HM Treasury

1 Horse Guards Road

London

SW1A 2HQ

[2] Financial Stability Board, 2011, *Key Attributes for Effective Resolution Regimes for Financial Institutions*: http://www.financialstabilityboard.org/publications/r_111104cc.pdf

1.25 When responding, please state whether you are doing so as an individual or representing the views of an organisation. If you have concerns about the way in which this document is being managed, please contact:

Tom Eland

Transport, Regulation and Competition

HM Treasury

1 Horse Guards Road

London

SW1A 2HQ

Consultation questions

- Do you agree that the four types of non-bank identified above – investment firms and parent undertakings, CCPs, non-CCP FMIs and insurers – are those that are most likely to have the potential to be systemically important?
- What other types of non-bank – if any – might have the potential to be systemically important? If there are any others that may be systemically important what policies should the Government adopt to mitigate the risk they pose to financial stability?

2 Investment firms and parent undertakings

General considerations

2.1 In February 2011, the Government introduced the Special Administration Regime (SAR), a bespoke administration procedure for investment firms. The SAR gives administrators three objectives that they have a duty to follow: to ensure the return of client money or assets as soon as is reasonably practicable; to ensure timely engagement with market infrastructure bodies and the authorities; and to either rescue the investment firm as a going concern, or wind it up in the best interests of creditors. In October 2011 MF Global Limited became the first firm to enter the SAR.

2.2 The Banking Act 2009 requires the Government to review the regulations governing the SAR by February 2013, reporting to Parliament on how far the regulations achieve their objectives and whether they should continue to have effect. The Government also intends to take the opportunity to look at broader issues arising from the MF Global administration, in particular obstacles to the timely return of client assets and money to investors. This review will be run in tandem with the Financial Services Authority's (FSA) review of its client assets rulebook. Further details will be announced shortly.

2.3 As set out in the Government's recent white paper on banking reform, while the SAR has strengthened the UK's ability to manage the failure of the majority of investment firms, it is not suitable for managing the failure of a systemic investment firm or its parent undertakings. The UK does not currently have resolution powers for investment firms – the Banking Act 2009 only enables resolution of deposit-taking institutions (typically, banks or building societies.) The Government intends to address this gap.

2.4 The UK, along with the other G20 and EU countries, is committed to implementing the FSB's Key Attributes. These require the introduction of resolution regimes for systemic investment firms and their parent undertakings. The UK also supports work led by the European Commission through the proposed RRD to design resolution regimes for investment firms and parent undertakings.

2.5 However, the timetable for the RRD is highly uncertain, given its complexity. Given the risk to stability presented by the failure of a systemic firm, the Government intends to prepare to legislate domestically on a more accelerated timetable, to provide a resolution regime for systemic investment firms.

2.6 The Commission's proposed RRD also requires the extension of Member States' resolution powers to parent undertakings of investment firms and deposit-taking institutions. This is in line with the FSB's Key Attributes and reflects the possibility of the need for action to be taken at the parent undertaking level if a systemic firm is to be resolved effectively.

2.7 Just as the UK does not have resolution powers available for investment firms, it does not have resolution powers for the parent undertakings of investment firms. And the Banking Act 2009 limits the stabilisation tools that are available to the parent undertakings of even deposit-taking institutions. Currently, the only stabilisation option would be to take the parent undertaking into temporary public ownership. The Government therefore also intends to prepare to legislate to extend the full resolution regime to the parent undertakings of both systemic investment firms and deposit-taking institutions.

2.8 The Government's intended legislation has been designed to be consistent with the proposed RRD (with regard to the availability and design of resolution regimes), the FSB's Key Attributes and the existing Banking Act 2009. This consultation document explains the proposed regime and highlights any departures from the UK's existing SRR for deposit-taking institutions. Any departures have been made to reflect the difference in nature of investment firms (compared with deposit-taking institutions) and the specifics of UK law and European law.

2.9 To aid responses this consultation document includes certain key indicative clauses that set out how the Government would expect these policies to be implemented through legislation.

Scope of firms that would be captured by a new resolution regime

Investment firms in scope

2.10 Whether or not a financial institution is systemic depends on a number of factors. Many of these factors, such as the size of a firm's balance sheet, its exposures to other institutions or its role in facilitating wider market operations, are unlikely to shift in a short period of time. Some factors though will depend on conditions in the wider financial market at the point of failure.

2.11 Most significantly, confidence in the soundness and stability of the UK's and the global financial system will depend on conditions at the time. This context is critical to any judgement of the systemic nature of a firm. The Government therefore judges it inappropriate to set out in legislation a prescriptive definition of *systemic* investment firms. A restrictive description could prevent necessary action to resolve a firm which had been perceived to be non-systemic until the point of its failure. The Government therefore proposes to capture all investment firms incorporated (or otherwise constituted) in the UK. The proposed definition for 'investment firms' for the purpose of the resolution regime is as follows:

Definition

"In this Act "investment firm" means a UK institution which is an investment firm for the purposes of Directive 2006/49/EC on the capital adequacy of investment firms and credit institutions."

Banks and other firms which are currently resolvable under the Banking Act might fall within this definition of "investment firm", so the legislation will set out exclusions from the definition to make clear which resolution provisions, and which resolution objectives, apply to which firms.

2.12 The authorities would, however, only ever seek to resolve a *systemic* investment firm. Non-systemic firms – and it is expected that the vast majority of investment firms operating in the UK are non-systemic – would be entered into the existing SAR. To enable this, upon failure the proposed stabilisation powers would only be exercisable to resolve a *systemic* firm.

2.13 The intended legislation would follow the same arrangements as exist for deposit-taking institutions (set out in the Banking Act 2009) in incorporating a public interest condition, which effectively requires a test of systemic importance. That is, before being able exercise a stabilisation power to resolve a failing investment firm, the Bank of England (the Bank), as resolution authority, and in consultation with HM Treasury and the firm's regulator, must be satisfied that the exercise of stabilisation powers is necessary to the public interest in ensuring the stability of and confidence in the UK's financial systems. Unlike the Banking Act 2009, the test does not include a condition relating to protection of depositors. The intended legislation will include an additional objective to which the Bank must have regard in exercising stabilisation powers to resolve a systemic investment firm, concerning the protection of client funds and client assets. The Bank would be expected to consider the impact of a disorderly failure on the clients of the firm in question in determining whether the public interest conditions are met.

The inclusion of parent undertakings in scope

2.14 As set out above, the Government wishes to ensure that the legal structure of financial and mixed holding companies does not prevent or undermine the effective resolution of a systemic investment firm or deposit-taking institution. In situations in which critical assets are owned by a parent undertaking (e.g. group headquarters) or critical staff are employed by the parent undertaking, a stabilisation transfer power applied at the level of the parent undertaking would allow those critical functions to be transferred to a bridge entity or purchaser, alongside the institution being resolved.

2.15 The legislation will therefore allow for the full range of stabilisation powers to be exercised at parent undertaking level, and will do so in relation to parent undertakings of both investment firms and deposit-taking institutions.

2.16 The authorities would only want to intervene in a holding company where it is necessary to do so in order to achieve the objectives of the resolution regime, and where those objectives cannot be achieved only exercising resolution powers and tools on the investment firm itself. The authorities would also want to intervene in a holding company without, as far as possible, impacting on any wider, non-financial activities. So as to ensure powers are used in this targeted way, legislation will impose some qualifications on the level of intervention enabled within a holding company:

- 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 exists and owns the systemic financial subsidiary, stabilisation powers will only be exercised at this intermediary level, rather than at the top holding company level.

2.17 The intended legislation will only provide resolution powers for firms and parent undertakings incorporated in the UK. The proposed application of the regime to parent undertakings is as follows:

Application of resolution regime to parent undertakings

1. The Bank of England may exercise a stabilisation power in respect of a parent undertaking of a bank ("the holding company") in accordance with section 11(2) or 12(2) if the following conditions are met.
2. Condition 1 is that the PRA is satisfied that the general conditions for the exercise of a stabilisation power set out in section 7 are met in respect of the bank.
3. Condition 2 is that the Bank of England is satisfied that it is necessary to take action in respect of the holding company for the purpose specified in Condition A or B of section 8.
4. Condition 3 is that the holding company is an undertaking incorporated in, or formed under the law of any part of, the United Kingdom.
5. Expressions used in this section have the same meaning as in the Companies Act 2006.

This provision would also apply to holding companies of investment firms. The legislation will contain a provision that applies Part 1 of the Banking Act 2009 to investment firms, so the references in the draft above to banks and to holding companies of banks would include investment firms and their holding companies.

Designing the regime: triggers, objectives, stabilisation powers and safeguards

Trigger conditions for intervention

2.18 Any decision to exercise stabilisation powers in relation to a systemic investment firm would be a very significant step. To ensure that intervention is only taken where absolutely necessary the resolution regime will include a regulatory trigger similar to that which exists in the Banking Act 2009. The legislation would require the relevant firm's regulator to be satisfied that the firm is failing, or likely to fail, its regulatory threshold 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. The regulator – which under Government's proposed reforms to the regulation of the finance sector could be either the Prudential Regulation Authority (PRA) or the Financial Conduct Authority (FCA) – would be required to consult with the wider UK authorities in reaching this latter judgement.

2.19 As set out above, even if the trigger conditions are met, resolution action would only be taken if the firm's failure were also considered to be of systemic importance, otherwise it would enter into the SAR.

Objectives for the resolution of investment firms and parent undertakings

2.20 There are many similarities between investment firms and deposit-taking institutions. This means the design of the existing SRR is broadly applicable to investment firms. However, a key difference is the need to protect client assets as well as depositors.

2.21 The failure of Lehman Brothers in September 2008 also highlighted the inter-connectivity of markets through financial market infrastructure and the challenges that disorderly failure can present to regular market operations. Orderly resolution of a systemic investment firm should mitigate the majority of these disruptive events but it will be important to ensure that resolution itself does not unduly interfere with market infrastructure operations.

2.22 The intended legislation will therefore set out the following additional objectives to be followed in exercising stabilisation powers to resolve a systemic investment firm:

- protection of client funds and client assets; and
- avoiding unnecessary interference with the operations of financial market infrastructure.

The additional objectives of the resolution regime for investment firms are as follows:

> Resolution objectives
>
> 8A Objective 6, which applies in any case in which client assets (as defined in section 232(4)) may be affected, is to protect those assets.
>
> 8B Objective 7 is to minimise adverse effects on institutions (such as investment exchanges and clearing houses) that support the operation of financial markets.
>
> *These new objectives would be added to the list of special resolution objectives in section 4 of the Banking Act 2009. Objective 6 refers to the definition of client assets in section 232(4), which is "assets which an institution has undertaken to hold for a client (whether or not on trust and whether or not the undertaking has been complied with)".*

Design of stabilisation powers

2.23 The Government intends that legislation will allow the authorities to exercise for systemic investment firms, their parent undertakings and the parent undertakings of deposit-taking institutions, the same broad suite of powers that exist within the SRR. These powers are designed to allow the authorities to resolve a systemic firm in all failure scenarios whilst minimising any recourse to public funds. These powers are also broadly similar to those contemplated in the draft RRD with the notable exception of the explicit bail-in power in the RRD. As set out in the banking reform white paper published in June (which also consults on a number of technical questions on bail-in), the Government expects bail-in to be implemented in the UK through the transposition of the RRD.

2.24 The proposed RRD includes an additional stabilisation power in the form of the transfer of assets to an asset management vehicle. It also enables the use of a short stay on the exercise of early termination and close-out netting rights in financial contracts held by counterparties of a failed firm. The Government does not intend to introduce these powers separately from the European process since (i) the RRD specifies that the asset management vehicle tool can only be used in conjunction with another RRD stabilisation tool, so it makes sense to consider this only as part of an overall RRD package; and (ii) a stay would to some extent be dependent on amending existing European legislation to be effective.

2.25 The stabilisation options available to the Bank, as resolution authority, and in consultation with the wider UK authorities, would be:

- to transfer some or all of the securities or business of a firm or its parent undertaking to a commercial purchaser; and
- to transfer all or some of the securities or business of a firm or its parent undertaking to a 'bridge firm' (a company owned and controlled by the Bank).

2.26 The intended legislation would also provide HM Treasury, in consultation with the wider UK authorities, with the power to transfer securities of a firm into temporary public ownership.

2.27 It would also continue the existing provisions for protecting public funds. Any decision by the Bank requiring the use of, or with implications for, public funds will require the authorisation of the Chancellor.

2.28 In addition to the main stabilisation powers, the intended legislation would also extend the ancillary powers that exist for the SRR (set out in sections 14 to 48A of the Banking Act 2009) together with the provisions for compensation arrangements (sections 49 to 62).

Safeguards

2.29 Safeguards to protect property rights during the exercise of the partial property transfer power will be established by secondary legislation. These are expected to closely follow the safeguards for the existing SRR.

2.30 As with the SRR for banks, the intended legislation would also require HM Treasury to prepare a statutory code detailing how powers would be used for the resolution of investment firms and their parent undertakings. The code would be made by HM Treasury under primary legislation and laid before Parliament.

2.31 The code would follow the same structure as for the SRR but without reference to the special insolvency procedure set out in the Banking Act 2009, since this would not be replicated for investment firms. The SAR already provides a bespoke insolvency procedure for investment firms.

2.32 The intended legislation would also require the existing code of practice for the SRR to be extended to detail how stabilisation powers would be used in relation to the parent undertaking of a deposit-taking institution.

Summary of the Government's position

2.33 Investment firms clearly have the potential to be systemic and, in failure, to pose a risk to the UK's wider financial stability.

2.34 In line with its G20 and European commitments, the Government intends to prepare to legislate to introduce a resolution regime for systemic investment firms incorporated in the UK. This regime would be extended to capture the parent undertakings of systemic investment firms and deposit-taking institutions.

2.35 The Government would welcome views on the proposed design of this regime.

Consultation questions

- What are your views on the UK introducing resolution powers for these firms in advance of conclusion of the negotiation of the RRD?
- Is the definition for investment firm set out above appropriate?
- Are the conditions by which the Bank is required to judge the necessity of exercising stabilisation powers correct?
- Should any further safeguards be applied to qualify the use of powers within a financial or mixed holding company?
- What should be considered the financial elements of a holding company? Should the authorities define 'financial elements' in the face of the legislation or in the accompanying code of practice?
- Is the existing public interest test sufficient for defining the level of the authorities' possible intervention in a holding company?
- Do you agree with the trigger condition for enabling the exercise of stabilisation powers?
- Do you agree with the suite of stabilisation powers proposed for systemic investment firms and parent undertakings?
- Do you agree with the Government's intention not to include a power to transfer assets to an asset management vehicle in the suite of stabilisation powers?
- Are any further safeguards necessary for the resolution of systemic investment firms and parent undertakings?
- Are there any additional areas a code of practice should cover that are particularly relevant to systemic investment firms or parent undertakings?
- Should the existing Banking Liaison Panel – established under the Banking Act 2009 – be extended, in its current form, to advise on the effect of the intended regime for investment firms?

3 Central counterparties

General considerations

3.1 Central counterparties (CCPs), also known as clearing houses, form part of the financial market infrastructure that underpins the operations of UK, European and global financial markets. CCPs interpose themselves in certain financial transactions, acting as the buyer to every seller and the seller to every buyer, in order to protect trading parties from the risk of counterparty default.

3.2 The financial crisis served to highlight the importance of clearing in financial markets as a means of improving transparency and addressing deficiencies in counterparty risk management in the over-the-counter (OTC) derivatives markets. The crisis also revealed a number of problems in derivatives markets – most notably, deficiencies in the management of counterparty credit risk and a lack of transparency regarding risk concentrations.

3.3 At the G20 meeting in Pittsburgh in 2009, leaders agreed: "To this end, all standardised OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest."[1] Along with other EU Member States, the European Commission and the European Parliament, the Government has completed negotiations on the European Market Infrastructure Regulation (EMIR) which takes forward the clearing aspects of the Pittsburgh agreements. Once fully implemented, EMIR will lead to a significant increase in the volume and range of derivatives that will need to be centrally cleared through a CCP. There remains a significant loophole in European legislation which means that derivatives already traded do not have to be centrally cleared; the Government is pressing for this loophole to be closed in the interests of mitigating systemic risk in line with the objectives of the G20 agreement.

3.4 The crisis also demonstrated the inter-connectedness of the financial sector and the size and extent of exposures that accrue between financial institutions. The role performed by CCPs means that they are particularly exposed to wider market risks, such as the failure of large clearing members. This exposure will increase as EMIR is implemented.

3.5 UK CCPs weathered the last financial crisis well; they are governed by robust regulatory arrangements and have in place a number of defences against failure. Members of a CCP are required to post significant levels of collateral against the value of their (or their clients') positions and this is pegged to the changing risk of the trade and the markets. Further, CCPs typically maintain default funds, contributed to by members, and these act as a buffer against extraordinary losses. CCP's own capital reserves act as an additional buffer.

3.6 Despite this, there is a risk that extreme market conditions, like those experienced in the past crisis, could threaten the financial soundness of a CCP. The unexpected failure of its largest members, alone or combined with a general decline in the value of posted collateral or losses arising from other business risks, could lead to losses in excess of those which CCPs are protected against.

[1] G20, 2009, *Pittsburgh summit declaration*: http://g20.org/images/stories/docs/eng/pittsburgh.pdf

3.7 Since the financial crisis, and reflecting their growing importance, the UK, as part of wider international efforts, has taken a number of steps to limit the likelihood of a CCP failing and EMIR will put in place stringent regulatory requirements for CCPs. These include requirements on the amount of permanent and available initial capital, strict rules as to the eligible collateral suitable for a CCP to collect from clearing members, the need to maintain a default fund and rules concerning the investment policy of a CCP's own funds.

3.8 CCPs and their members have also begun to implement for some business lines rules and procedures to distribute losses amongst members in the event that a CCP is exposed to uncovered losses. This is strongly supported by the authorities who are in consultation with the industry on how best to ensure rules, which are seen as an important additional line in a CCP's defences, are designed and implemented effectively. It is crucial that CCPs and their members continue to take steps to reduce the likelihood of a CCP failing, such as through insuring against failure or scenarios likely to lead to failure.

3.9 Increasingly global financial markets have also resulted in the development of multicurrency infrastructures which permit clearing operations in a number of different currencies. There are significant synergies in clearing or settling a product denominated in one currency alongside the same and similar products denominated in other currencies. Efficiencies can also be derived from netting. This gives rise to economies of scale and scope, and ultimately generates improved market efficiency, which is also helpful to stability.

3.10 But there remains a need to prepare for exceptional circumstances that could result in the failure of a CCP. The Government shares the FSB's assessment of the risk to stability posed by the disorderly failure of a CCP. CCPs can, like banks and investment firms, be clearly systemic, not only due to the significant exposures CCPs have to other market participants but, more importantly, because of their critical role in the operation of markets. The disorderly failure of a significant CCP, or closure of its critical clearing services, would result in severe disruption to trading in large parts of the financial markets. To this end the FSB has also identified the need for a resolution regime for CCPs. And CPSS-IOSCO is expected to publish recommendations on the resolution of FMIs – including CCPs – around the date of this consultation document.

3.11 The disruption to trading by the failure of a CCP would be most extreme where a failed CCP is the only clearer for a given asset class, such as where CCPs are part of integrated market structures that are closed to direct competition. This could create an even more systemic single point of failure in the system, extending beyond CCPs to affiliated trading platforms or other infrastructure within the same closed structure. Discussions to require fair and non-discriminatory access between trading venues and clearing providers are underway in the EU, as proposed by the European Commission in the Markets in Financial Instruments Directive (MiFID) Review. In addition, it will be important that licences for benchmarks on which financial instruments (including many derivatives products) are based are available on a fair and commercial basis to all market participants. Such provisions provide a critical underpinning to European work on resolution, as without them it would be more challenging to ensure continuity of service in certain instances of resolution by substituting to another provider.

3.12 Sensible risk management also calls for consideration of additional transparency around the operation of clearing houses and resolution planning in order to strengthen market confidence and resilience.

3.13 The UK expects that, in due course, the European Commission will propose measures to require Member States to introduce resolution regimes for CCPs in line with, or closely following, recommendations set out by CPSS-IOSCO. But the timetable for this is unclear – CCPs are not within the scope of the RRD – and could be a number of years.

3.14 The Government therefore intends to prepare to legislate domestically in line with international principles, to provide powers to resolve a CCP incorporated in the UK. In broad terms, the Government envisages that the powers will comprise securities and property transfer powers broadly similar to those available under Part 1 of the Banking Act 2009 (the SRR) for banks. A key element of this work relates to timely information sharing and cooperation between authorities in different jurisdictions – the Government would expect the UK resolution authorities to fully live up to these principles in the performance of their duties.

Scope of the intended resolution regime

3.15 The Government's proposed resolution regime for CCPs would capture any Recognised Clearing House[2] incorporated in the UK. The proposed definition of 'clearing house' for the purposes of the resolution regime is as follows:

Definition

"UK clearing house" means a clearing house—

1 which has its head office or its registered office (or both) in the United Kingdom,

2 which provides central counterparty clearing services, and

3 in relation to which a recognition order is in force under Part 18 of FSMA 2000.

3.16 The authorities would though only wish to resolve a *systemic* CCP, since intervention and the possible use of public funds can only be warranted where there is a risk to wider financial stability or to public confidence in the stability of the financial systems of the UK. To enable this, the intended legislation would incorporate a public interest condition, which effectively requires a test of 'systemic importance' for this purpose, ensuring specified conditions are met (as set out below). That is, before being able to exercise a stabilisation power to resolve a failing clearing house, the Bank, as resolution authority, and in consultation with the wider authorities, must be satisfied that the exercise of stabilisation powers is necessary in pursuance of specified public interest aims. The Government would also expect the Bank to consider the impact on financial stability in Europe and internationally, given the interconnected nature of global financial markets.

Designing the regime: triggers, objectives, stabilisation powers and safeguards

Trigger for intervention

3.17 It is crucial that threats to financial stability arising from the failure or near failure of a clearing house can be fully mitigated, including through ensuring the continuity of critical clearing services. The intended legislation would therefore enable the resolution authority to be able to exercise stabilisation powers ahead of a clearing house becoming insolvent, or otherwise ceasing to provide critical clearing services, provided it is, in the opinion of the resolution authority, in the public interest to do so.

3.18 The intended legislation would therefore enable a clearing house's regulator to be able to trigger consideration of resolution action if a clearing house has 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. But the regulator would only be able to do so where it is not likely that action other than the deployment of a stabilisation tool would enable the clearing house to once again meet these conditions, or where, notwithstanding that other action may restore the clearing house to

[2] Under Part 18 of the Financial Services and Markets Act 2000.

compliance with those conditions, that action would undermine the continuity of clearing services. This latter determination would be made in consultation with the wider UK authorities.

3.19 The design of some loss allocation rules by CCPs to date can require the closure of affected business lines in order to limit liabilities of members. This could conflict with the authorities' objectives to maintain critical clearing services in support of wider financial stability. It is also the Government's intention that the UK resolution authorities act in a cooperative and coordinated manner with international counterparts, and in line with international principles that there should be no legal barriers to information sharing with all interested authorities.

3.20 Therefore, the intended legislation would enable intervention by the resolution authority in order to ensure the continuity of clearing services if action, or inaction, by the clearing house to restore itself to compliance with its requirements would otherwise undermine this. This might be the case, for example, if such action, or inaction, would cause the closure of a business line critical to the markets' operations. Such an approach is consistent with the FSB's Key Attributes and the Government also expects it to be consistent with the recommendations on the resolution of FMIs – including CCPs – due to be published by CPSS-IOSCO around the date of this consultation document.

3.21 As such, an indicative draft of the 'general' and 'specific' conditions which must be satisfied in order that a stabilisation power may be exercised are as follows (it is assumed that these provisions would come into force following the commencement of the relevant provisions of the Financial Services Bill which make a number of amendments to the Financial Services and Markets Act 2000 (FSMA), including conferring on two new regulators (the PRA and the FCA) as appropriate the majority of the FSA's functions under the FSMA):

General conditions

1 A stabilisation power may be exercised in respect of a UK clearing house only if the Bank of England is satisfied that the following conditions are met.

2 Condition 1 is that the clearing house is failing, or is likely to fail, to satisfy the requirements resulting from section 286 of FSMA 2000 (requirements for recognition).

3 Condition 2 is that having regard to timing and other relevant considerations it is not reasonably likely that (ignoring the stabilisation powers) action will be taken by or in respect of the clearing house that will enable it to satisfy those requirements while maintaining the continuity of the provision of central counterparty clearing services.

4 The Bank must treat Conditions 1 and 2 as met if satisfied that they would be met but for financial assistance provided by—

  a the Treasury, or

  b the Bank (disregarding ordinary market assistance offered by the Bank on its usual terms).

5 Before determining whether Condition 2 is met the Bank must consult—

  a the Treasury;

  b (if the clearing house is a PRA-authorised person) the PRA;

  c (if the clearing house has a Part 4A permission but is not a PRA-authorised person, or if the clearing house is a recognised investment exchange) the FCA.

6 The special resolution objectives are not relevant to Conditions 1 and 2.

Specific conditions

1. The Bank of England may exercise a stabilisation power in respect of a UK clearing house only if it is satisfied that the exercise of the power is necessary, having regard to the public interest in—
   a. the stability of the financial systems of the United Kingdom, and
   b. the maintenance of public confidence in the stability of those systems.
2. Before determining whether the condition in this section is met, the Bank of England must consult:
   a. the Treasury;
   b. (if the clearing house is a PRA-authorised person) the PRA;
   c. (if the clearing house has a Part 4A permission but is not a PRA-authorised person, or if the clearing house is a recognised investment exchange) the FCA.
3. The condition in this section is in addition to the conditions in section 2 (general conditions).

Interpretation

In this group of sections—

"central counterparty clearing services" has the same meaning as in section 155 of the Companies Act 1989 (see subsection (3A) of that section),

"the FCA" means the Financial Conduct Authority,

"FSMA 2000" means the Financial Services and Markets Act 2000,

"Part 4A permission" has the same meaning as in FSMA 2000 (see section 55A(5) of that Act),

"the PRA" means the Prudential Regulation Authority,

"PRA-authorised person" has the same meaning as in FSMA 2000 (see section 2B(5) of that Act), and

"UK clearing house" means a clearing house—

1. which has its head office or its registered office (or both) in the United Kingdom;
2. which provides central counterparty clearing services; and
3. in relation to which a recognition order is in force under Part 18 of FSMA 2000.

3.22 To provide the authorities with sufficient time to make this consideration, the intended legislation would also enable the Bank or the regulator to prevent a clearing house from being placed into an insolvency procedure until the Bank had decided whether or not to exercise a resolution power. This is consistent with existing measures available in relation to banks (for example under section 120 of the Banking Act 2009 (notice to the FSA of preliminary steps)).

3.23 The intended legislation would also provide the clearing house's regulator with an expanded power of direction, capable of being exercised to protect financial stability and market confidence. The Government considers such a power necessary to ensure that the regulator is able to protect against action by a clearing house, or a failure to act, that might precipitate its failure or undermine effective resolution action.

3.24 It is envisaged that the proposed power of direction would be inserted into the FSMA, as amended by the Financial Services Bill (see clauses 26 to 32 and schedule 7 to the Bill as introduced to the House of Lords[3]). Accordingly, it is envisaged that the regulator could, in the event of a breach of a direction, impose sanctions (see new sections 312E to 312K as inserted by clause 30) in addition to considering revocation of the clearing house's status as a recognised body. Furthermore, it is envisaged that the power of direction would be capable of being exercised on an expedited basis (see section 298 of the FSMA (directions and revocation orders) as modified by clause 29 of the Bill).

3.25 A indicative draft of the clause concerning the new power of direction is set out below:

Power to direct UK clearing houses

1 The Bank of England may direct a UK clearing house to take, or refrain from taking, specified action if the Bank is satisfied that it is desirable to give the direction, having regard to the public interest in—

  a protecting and enhancing the stability of the UK financial system,

  b maintaining public confidence in the stability of the UK financial system,

  c maintaining the continuity of the central counterparty clearing services provided by the clearing house, and

  d maintaining and enhancing the financial resilience of the clearing house.

2 The direction may, in particular—

  a specify the time for compliance with the direction,

  b require the rules of the clearing house to be amended, and

  c override such rules (whether generally or in their application to a particular case).

3 The direction is enforceable, on the application of the Bank, by an injunction or, in Scotland, by an order for specific performance under section 45 of the Court of Session Act 1988.

4 In this section—

"central counterparty clearing services" has the same meaning as in section 155 of the Companies Act 1989 (see subsection (3A) of that section), and

"UK clearing house" means a clearing house—

1 which has its head office or its registered office (or both) in the United Kingdom,

2 which provides central counterparty clearing services, and

3 in relation to which a recognition order is in force under Part 18 of the Financial Services and Markets Act 2000.

[3] A copy of the Bill is available here: http://services.parliament.uk/bills/2012-13/financialservices.html

Objectives for operation of a resolution regime for CCPs

3.26 The objectives of the authorities for the resolution of clearing houses would closely follow those already set out in section 4 of the Banking Act 2009 (special resolution objectives). This reflects the shared goal of protecting financial stability with minimum disruption to the wider financial markets and whilst respecting property rights in so far as possible. But an additional objective would be added as part of the intended legislation to reflect the need to maintain the continuity of the provision of critical central counterparty clearing services. The intended set of resolution objectives are as follows:

Resolution objectives

1 This section sets out the special resolution objectives.

2 The relevant authorities must have regard to the special resolution objectives in using, or considering the use of, the stabilisation powers.

3 For the purposes of this section the relevant authorities are—

a the Treasury, and

b the Bank of England.

4 Objective 1 is to maintain the stability of the financial systems of the United Kingdom.

5 Objective 2 is to protect and enhance public confidence in the stability of the financial systems of the United Kingdom.

6 Objective 3 is to maintain the continuity of the provision of central counterparty clearing services.

7 Objective 4 is to protect public funds.

8 Objective 5 is to avoid interfering with property rights in contravention of a Convention right (within the meaning of the Human Rights Act 1998).

9 The order in which the objectives are listed in this section is not significant; they are to be balanced as appropriate in each case.

Stabilisation powers for CCPs

3.27 The intended legislation would confer on the Bank, as resolution authority, a suite of stabilisation powers to prevent the disorderly failure of a systemic clearing house. These powers would broadly follow the design of the existing stabilisation powers under the SRR for banks, namely enabling the transfer of securities, property, rights and liabilities of the clearing house to another person, such as a private sector purchaser or a 'bridge' CCP owned and controlled by the Bank as resolution authority.

3.28 The intended legislation would also ensure that any such application of the stabilisation powers does not count as a default event for any contracts with the CCP. This is designed to ensure the continuity of clearing functions (as such it is envisaged that powers similar to sections 22 and 38 of the Banking Act 2009 (termination rights etc.) would be made available to the resolution authority).

3.29 In order to ensure that clearing services remain uninterrupted, the Government also plans to enable the Bank to transfer membership agreements, preserving the position of each member together with the rules of operation of the failed clearing house for a specified period of time (or until a specified occurrence) and to be able to make modifications to these arrangements. As with the existing SRR the intended legislation would also provide the Bank, as resolution authority, with supplemental, reverse and onward transfer powers (e.g. similar to those available under sections 42, 43 and 44 of the Banking Act 2009).

3.30 The Bank would also be provided with a power of direction over an insolvency practitioner appointed in relation to a clearing house (whether or not the clearing house has been subject to an exercise of the stabilisation powers), primarily so the resolution authority is able to ensure the continuity of support services to a resolved firm or to ensure that the effects of the entry of a clearing house into an insolvency procedure on the markets are minimised. It is envisaged that any person subject to the power of direction would be immune from liability in damages for any action taken (or inaction) in good faith in accordance with the direction (providing that the action was not in contravention of section 6 of the Human Rights Act 1998).

3.31 CCPs, which may be profit-making or member owned, function to support the operations of the financial sector. Members and owners of CCPs therefore have a vested interested in ensuring their solvency and continued operations. But, as noted above, there is a risk that a CCP's default arrangements and any loss allocation rules will be insufficient to meet all losses. To prevent the CCP failing and terminating some or all of its operations, these losses may need to be met elsewhere.

3.32 The Government is of the view that taxpayers should not be expected to meet the cost of restoring a clearing house to viability but that it should be met by owners and members of the clearing house.

3.33 The Government is therefore considering the case for providing the resolution authority with additional stabilisation powers to impose liabilities on members of a CCP (potentially subject to some kind of capped arrangement), to require them to contribute funds to restore a clearing house to viability (e.g. by meeting uncovered losses and to replenish default funds), and to ensure that shareholders bear their fair share of losses.

Safeguards

3.34 The regime will ensure that creditors are not discriminated against on grounds of nationality and will be operated in a fashion consistent with existing European law.

3.35 Safeguards to protect property rights in resolution will be set out in accompanying secondary legislation. The Government expects that safeguards would include, amongst others, those already available in respect of partial property transfers under the SRR for banks. The Government also expects to replicate the Banking Act 2009 powers to put in place compensation arrangements following an exercise of the stabilisation powers.

3.36 As with the SRR, the intended legislation would require HM Treasury to prepare a statutory code detailing how it is anticipated that the stabilisation powers would be used for the resolution of clearing houses (see sections 5 and 6 of the Banking Act 2009 (code of practice and procedure)).

3.37 The code would follow the same structure as for the SRR but be adapted to the nature of CCPs and their proposed resolution regime.

Summary of the Government's position

3.38 CCPs clearly have the potential to be systemic and, in failure, pose a risk to the UK's wider financial stability. This is due to the critical role clearing plays in the operations of the financial sector.

3.39 In line with its G20 commitments the Government intends to prepare to legislate to introduce a resolution regime for CCPs incorporated in the UK.

3.40 The Government would welcome views on the proposed design of this regime.

Consultation questions

- Do you agree with the scope of the intended resolution regime extending to all Recognised Clearing Houses incorporated in the UK which offer central counterparty clearing services?
- Are there any further options available to CCPs, their members and markets to reduce the likelihood of a CCP failing?
- Do you agree that measures that support substitutability of clearing services (e.g. through non-discriminatory access provisions and access to licences on a reasonable commercial basis) are an important underpinning to an effective regulatory and resolution regime?
- Are there any areas where you consider that CCPs should become more transparent about their risk management practices and resolution planning?
- Do you agree with the use of the failure, or likely failure, to meet its conditions for recognition as the general trigger for possible intervention in a clearing house?
- Do you agree with the specific conditions which must be satisfied before a stabilisation power may be exercised?
- Do you agree that the authorities should be able to intervene ahead of action taken by the clearing house to restore its financial position, but only in order to prevent disruption to or termination of critical clearing services consistent with the financial stability objective?
- Do you agree with the intended objectives of a resolution regime for clearing houses?
- Do you agree with the proposed suite of stabilisation powers for clearing houses?
- Do you think there are any additional stabilisation powers necessary to be able to resolve a clearing house in all scenarios for failure?
- Do you agree that the resolution authority should be able to impose losses on members of a failing clearing house as part of resolution action? Should this be applicable to losses arising from any circumstance?
- Should any such liabilities be capped and, if so, how should such a cap be structured and its level determined?
- Do you agree with the proposed safeguards? If not, what additional safeguards should the authorities consider in exercising the stabilisation powers in relation to a clearing house?
- Are there any specific areas the code of practice should cover that are particularly relevant to CCPs?
- Do you agree with the proposed power of direction over insolvency practitioners? Do you agree with the circumstances in which this power is intended to be exercisable? What safeguards do you consider should apply?
- Should the existing Banking Liaison Panel – established under the Banking Act 2009 – be extended, in its current form, to advise on the effect of the intended regime on CCPs?

4 Non-CCP financial market infrastructures

General considerations

4.1 As discussed in Chapter 3, the disorderly failure of a CCP has the potential to have a significant adverse impact on financial stability. But in addressing gaps in the resolution framework for non-banks, it is also important to consider other financial market infrastructures (FMIs), including:

- payment systems;[1]
- central securities depositories and securities settlement systems;
- exchanges and trading platforms; and
- trade repositories.[2]

4.2 There is currently no standing resolution regime for these FMIs. They are therefore subject to ordinary UK insolvency law, with administration and liquidation as available insolvency mechanisms. However, should an FMI be placed into an insolvency process, it is possible that there would be a cessation in the provision of critical services. In the event of a disorderly failure, this would be likely to result in severe disruption to the UK financial system as typically there are often very few providers of a particular FMI service – and in some cases only a single provider.

4.3 The owners and members of FMIs may well be strongly incentivised to ensure continuity of service, in particular where the members are banks which would themselves suffer from disruption and reputational damage if there was a break in the provision of service. And the fact that these (non-CCP) FMIs do not take credit risk and have relatively low running costs means that a market-led solution to the threat of failure of an FMI may well be a feasible option.

4.4 But bearing in mind the disruption that could result from a failure, the Government is keen to investigate whether the arrangements for coping with the failure of (at least some) non-CCP FMIs should be strengthened. This could provide the authorities with the ability to intervene if necessary in order to prevent a disorderly failure, ensure the continuity of critical services and further incentivise owners and members to reach a solution in order to avoid the need for such intervention.

Improving the regulatory framework for managing the failure of non-CCP FMIs

4.5 The two broad approaches for improving the ability of the authorities to deal with a failing non-CCP FMI are:

- strengthening the existing insolvency arrangements to ensure that the available insolvency mechanisms are adequate; and
- developing a new, comprehensive resolution framework.

[1] Note that the Government is currently running a separate consultation on the regulation and governance of UK payments networks: http://www.hm-treasury.gov.uk/consult_setting_strategy_uk_payments.htm

[2] The proposed EU Regulation on OTC derivatives, central counterparties and trade repositories (EMIR) will transfer responsibility for the supervision of trade repositories established in the UK to the European Securities and Markets Authority (ESMA) in due course.

4.6 Under both approaches, objectives, triggers for intervention, powers and safeguards would need to be carefully considered. Objectives could include (at least) some of those set out under the SRR for banks, such as maintaining financial stability and protecting public funds. In order to minimise uncertainty for market participants, it would be important to ensure that there was a clear trigger for intervention that was as close to insolvency as was consistent with achieving the objectives; a likely candidate would be a firm failing, or being likely to fail, to continue to meet its regulatory recognition/authorisation/operational requirements, with no reasonable prospect of remedial action to address this. The nature of any powers would very much depend on which of the two approaches was adopted. And safeguards that were consistent with the scope of the powers would need to be implemented.

4.7 Under the first approach, additional objectives and/or powers would need to be provided to the insolvency practitioner conducting the insolvency of an FMI. One option would be to create a modified administration regime – comparable to those that apply to utilities such as energy and water suppliers – under which the administrator would have a specific objective to ensure (at least temporary) continuity of service. This could be accompanied by additional powers such as stays on early termination rights and moratoria on payments to creditors, if necessary.[3]

4.8 Under the second approach, a new resolution regime would be put in place. In this case, examples of the types of tools that the authorities could be given include:

- transfer powers allowing for the transfer of some or all of a non-CCP FMI's operations to a third party provider or to a bridge institution controlled by the resolution authority;
- 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 in order to allow for continuity of service to be preserved (potentially subject to some kind of capped arrangement); and
- step-in powers under which the authorities could take over the management of the FMI, over-riding any insolvency process.

4.9 Which of these two approaches is likely to be optimal will depend on the particular circumstances. For FMIs of a certain type or size some form of improved insolvency arrangement may be sufficient. For a larger FMI, or one that provides a service of particular systemic importance, a new resolution regime may be more appropriate. And there may be some entities for which the current insolvency mechanisms are considered adequate.

4.10 Under both approaches, it is likely that there would be benefits to the authorities also having the power explicitly to mandate the development of a recovery and resolution plan for at least some FMIs. These resolution plans should contain a range of options that could be implemented by an FMI should it run into trouble, and include an assessment of the likely practicability and efficacy of each option.

4.11 Bearing in mind the significant differences in form and function of different FMIs, it may well be the case that a number of approaches are required. For example, in the case of some FMIs, such as payment systems, the company providing the infrastructure services may be distinct from the scheme operating company. In such circumstances, it will be important to consider the implications of failure of either type of company – something that will not be necessary where there is only a single legal entity involved.

[3] Subject to any necessary changes being made to EU law.

Current regulatory developments

4.12 There are a number of initiatives already under way that are relevant to considerations of ways in which the risks arising from the collapse of a non-CCP FMI could be mitigated. These include:

- the development by the FSB of its Key Attributes, which call for resolution regimes to be put in place for any firm whose failure could be systemic, including FMIs;
- the report published earlier this year by CPSS-IOSCO on principles for FMIs, and recommendations on the resolution of FMIs expected to be issued by CPSS-IOSCO around the date of this consultation document; and
- the draft RRD published by the European Commission in June. Although this does not explicitly cover FMIs, consideration needs to be given to potential interaction between these existing RRD proposals and resolving FMIs, and also the scope for European legislation to address recovery and resolution of FMIs in due course.

4.13 In developing policy to address the risks associated with the failure of a non-CCP FMI, the Government will obviously pay close attention to these other developments.

Summary of the Government's current position

4.14 The Government's view is that bearing in mind the systemic importance of at least some non-CCP FMIs, and the lack of substitutability of many FMI service providers, there is likely to be a strong case for enhancing the regulatory regime for the failure of FMIs. The Government is therefore keen to receive evidence, analysis and views on the degree of systemic importance of various non-CCP FMIs, how the risks of failure of such entities could be mitigated, and any risks and costs associated with different regulatory approaches.

Consultation questions

- Do you agree that the regulatory framework for dealing with the failure of at least some non-CCP FMIs needs to be enhanced?
- If so, what should be the criteria for determining whether a non-CCP FMI should be covered? Should companies providing critical services to FMIs be included?
- Is it sufficient to strengthen the existing insolvency framework, or should a new resolution regime be developed? Should the same approach apply to all non-CCP FMIs? Should some non-CCP FMIs be prioritised over others?
- How should improvements to the insolvency framework, or development of a resolution regime, be designed? In particular, what objectives, triggers for intervention, powers and safeguards should be put in place?
- What are the competition implications of taking forward the sorts of approaches discussed in this chapter? How could the reforms contemplated here be designed so that they promote competition?

5 Insurers

General considerations

5.1 The International Association of Insurance Supervisors (IAIS) is developing a methodology to identify any insurers whose distress or disorderly failure, because of their size, complexity and interconnectedness, would cause significant disruption to the global financial system and economic activity. In their November 2011 report 'Insurance and Financial Stability', the IAIS concluded that "while impacted by the financial crisis, insurers engaged in traditional insurance activities were largely not a concern from a systemic risk perspective. However, insurance groups and conglomerates that engage in non-traditional or non-insurance activities are more vulnerable to financial market developments and importantly more likely to amplify, or contribute to, systemic risk."[1]

5.2 The IAIS is currently consulting on its proposed methodology for identifying global systemically important insurers and has identified non-traditional insurance activities (i.e. derivatives trading, short term funding and financial guarantees) and interconnectedness with the financial system as the two most important categories in determining the degree of systemic importance of insurers. IAIS has indicated that the first list of global systemically important insurers, if any, is likely to be published in the first half of 2013.

5.3 The UK broadly agrees with the emerging analysis from the IAIS. Disruption to core insurance activities in themselves is unlikely to cause financial instability, but it is possible that insurance institutions have some degree of systemic potential, with that possibility increasing with:

- complexity of business model, in particular interconnectedness with banking models – a number of bancassurers failed or required state support during the ongoing instability, including Dexia, Fortis, ING and Lloyds Banking Group, and the Basel Committee has explicitly sought to address some of these risks;
- dependencies and inter-linkages with other financial institutions (including through undertaking non-traditional insurance activities);
- size of institution – sales of large portfolios of assets at fire-sale prices could create an equity market spiral and have a systemic impact; and
- the size of market share in insurance products that are necessary, or compulsory, for the functioning of economic activity.

5.4 There are instances in which the disorderly failure of some insurers could have an adverse impact. Below are some examples of potential impacts, although it is important to note that not every insurance failure would necessarily have these effects:

[1] International Association of Insurance Supervisors, 2011, *Insurance and Financial Stability*: www.iaisweb.org/view/element_href.cfm?src=1/14102.pdf

- Direct impact: capital and liquidity positions of market participants with financial exposures to the firm would be affected. Failure of an insurer with a particularly large market share in commercial markets such as liability, property and catastrophe, could impede economic activity;[2]

- Policyholder impact and public confidence: failure has the potential to undermine current and future policyholder confidence in the risk transfer function provided by insurance and the broader financial sector. For example, there is a risk that policyholders' interests may not be adequately protected in a run-off, as the capital buffer may be eroded before all benefits payable under long-term policies or claims of policyholders with exposure to long-tail liabilities are discharged. These policyholders may be unable to transfer to an alternative provider on the same terms or without incurring significant penalties;

- Indirect impact on financial markets: particularly where financial markets are stressed, the failure of an insurer may cause the sudden withdrawal of a significant source of funding for banks and the removal of a major player in capital markets. This could be worsened if the insurer (prior to its failure) or the liquidator (following its failure) determined that selling assets into the market would best serve the interests of shareholders/creditors as that could depress collateral values and thus impede banks' and other firms' access to liquidity. Market participants may also be unwilling to lend to firms if they do not know which of their counterparties is directly exposed to the failing insurer and so potentially impaired.

Improving the regulatory framework for managing the failure of insurers

5.5 Regardless of whether an insurer's failure has a systemic impact, it is clear that failure can have a significant impact on public policy objectives. The current UK framework for insurers' individual capital adequacy standards and the European Solvency II capital framework (to be implemented shortly) do not aim to ensure that no insurer ever fails. However, there is an expectation that at any time firms will hold sufficient capital so that the estimated likelihood of failure over the following 12 month period is very low (0.5 per cent).

5.6 Recognising the particular nature of insurance contracts and insurers' business models, the PRA will have two objectives for insurance supervision. It will seek both to secure an appropriate degree of protection for policyholders and, as needed, to minimise the adverse impact that the failure of an insurer or the way it carries out its business could have on the stability of the system.

5.7 With this in mind, the Government's overarching objectives for responding to insurer failure are that:

- any insurer should be able to exit the market without disorderly impact; and

- an appropriate degree of policyholder protection should be achieved, including, where appropriate, though continuity of cover.

5.8 At present, the UK does not have a standing resolution regime for insurers. Generally, failing insurers have been dealt with through a process known as 'run-off', in which a firm stops writing new business either voluntarily, or on withdrawal of permission, and existing liabilities mature or run off over time. This creates a risk of time subordination for policyholders whose contracts mature later, should the remaining capital buffer be eroded or if there are other general creditors to be repaid first. The firm could be required to seek external capital injections, but experience suggests that in many cases it may prove difficult to find a willing provider of

[2] Case studies of this type of interruption of real economic activity include withdrawal of trade credit insurance during the financial crisis, the failure of HIH in Australia in 2001 and the liability insurance crisis of 2001/02.

capital. Run-off may be combined with a scheme of arrangement, a mechanism under the Companies Act 2006 which, with the approval of 75 per cent in value of the creditors, allows the firm to restructure and/or settle its liabilities.

5.9 In addition, formal insolvency mechanisms are available in the form of modified administration (pursuant to the FSMA 2000 (Administration Orders Relating to Insurers) Order 2010)), liquidation or company voluntary arrangements. The incidences of UK insurers being put into administration or being wound-up have been low, with no incidences occurring during the recent financial crisis.

5.10 The Financial Services Compensation Scheme (FSCS), which was established under the FSMA, acts as the UK's compensation fund of last resort for customers of FSA authorised financial services firms (which includes insurers). This means that the FSCS protects policyholders if an authorised financial services firm were unable, or were likely to be unable, to pay claims against it.

5.11 For life insurance the FSCS also has an obligation, subject to certain conditions, to seek continuity of insurance for policyholders (either by a transfer of business or substitution of policies) and provide funds to support this. If the conditions are not met, or the FSCS is unable to secure continuity, the FSCS must pay policyholders compensation. For general insurance, the FSCS can either seek portfolio transfer or pay compensation. For both life and general insurance, the protection provided by the FSCS is limited to 90 per cent of the contractual benefits (although compulsory insurance is protected at 100 per cent). In Europe, the European Commission published a white paper on harmonisation of insurance guarantee schemes in July 2010, but is yet to bring forward a legislative proposal in this area.

5.12 The current framework for dealing with insurer failure has evolved over time and, in line with reviewing arrangements for other sectors, it is sensible to review the current framework and assess whether it can provide for any insurer and reinsurer to exit the market without a disorderly impact, and ensure an appropriate degree of policyholder protection, including, where appropriate, through continuity of cover.

5.13 This consultation will explore the options for managing the failure of insurance firms, along the following lines:

- reviewing the existing insolvency arrangements to ensure the available insolvency mechanisms are adequate to meet public policy objectives; and
- exploring the potential for a comprehensive set of resolution stabilisation tools, comparable to those in the SRR for deposit-takers, if there is sufficient evidence that such tools are needed to protect against systemic risk.

Reviewing existing insolvency mechanisms

5.14 In the UK, if an insurer becomes insolvent the insolvency proceedings that exist to deal with the firm include administration, liquidation and company voluntary arrangements. Those proceedings have been modified to some extent to deal with the particular issues facing insurers, but still largely use the same mechanisms that apply to any other company and have as their principal aim the protection of creditors, of whom policyholders are a particular type. The proceedings were not designed with policyholder protection in mind and offer relatively limited scope for ensuring the continuity of payments and protection that is likely to be required, in many cases, to achieve an appropriate degree of protection for policyholders. In particular:

- directors may become personally liable to make contributions in a subsequent winding-up of the insurer, if they continue to trade when an insolvency is likely, which incentivises cessation of payments to policyholders in the run-up to insolvency;

- the existing regime is triggered at the point where the insurer is already insolvent and therefore unable to pay claims in full, if at all; and
- insolvency may well bring into play the valuation provisions of the Insurers (Winding-Up) Rules 2001, which are intended to achieve a definitive valuation of policyholder claims, rather than allowing policyholders to continue receiving cover and benefits. They may also provide policyholders (especially those with with-profits policies) with far less by way of benefits than they would have received had their policies continued in force.

Administration and liquidation regimes for insurers

5.15 A modified administration regime exists for insurers, and this was last amended in 2010 to bring the requirements on administrators of insolvent insurance companies into line with those which already apply to liquidators.

5.16 In the modified regime, the administrator is required to carry out the insurer's contracts of long-term insurance with a view to restoring viability or transferring it as a going concern to another insurer (the administrator may choose to do similarly with business that is not long-term, but is not required to do so) and the administrator also has a duty to cooperate with the FSCS to deliver this outcome. The administrator may apply to court for the appointment of a special manager if it believes that would be in the interests of creditors. Paragraph 3 of schedule B1 to the Insolvency Act 1986 requires the administrator to perform his functions in the interests of the company's creditors as a whole, with the objective of:

- rescuing the company as a going concern;
- achieving a better result for the company's creditors as a whole than if the company had been wound up; or
- realising property in order to make a distribution to one or more of the preferential creditors.

5.17 In liquidation, the liquidator of a company which effects or carries out contracts of long-term insurance must carry out the long-term insurance part of its business with a view to it being transferred to a person who may lawfully carry out those contracts. A duty is therefore imposed on a liquidator (under section 377 of the FSMA) in relation to long-term business to continue to receive premiums and pay claims unless a court order otherwise directs (a so-called 'stop order'). However, a liquidator cannot take on new contracts of insurance.

5.18 In reviewing the insolvency regimes, the Government wants to ensure that there are no issues that may impede the continuity of payments and protection for policyholders, particularly (though not exclusively) long-term policyholders. In addition to the issues noted above, insolvency proceedings can impose significant costs and disruption on policyholders, as all costs (including those payable over time) have to be taken in one hit and are calculated on a forward looking basis since insolvency practitioners are obliged to give 'insurance debts' statutory priority over other unsecured creditors at the point of insolvency. This is difficult given that the claims of policyholders may not have crystallised and may not do so under the policies for many years thereafter.

5.19 Further, in administration, the administrator's objective to continue to administer the insurer's long term contracts with a view to securing a transfer appears to have equal status with the other objectives. This may pose a challenge for the administrator in circumstances where a solution that delivers continuity for policyholders might deliver a worse outcome for other creditors. It may also be difficult for an administrator to determine how far this duty extends in terms of his efforts to try and find a buyer for all or part of the business. The Government's view is that the authorities should have all the tools necessary to enable insurers to fail without disorderly impact and appropriately protect the interests of policyholders. The

Government is therefore keen to receive evidence and views on the best way of delivering these objectives and would welcome proposals for strengthening the existing insolvency mechanisms to achieve these outcomes.

Financial Services Compensation Scheme (FSCS)

5.20 The successful resolution of a failing insurer is also dependent on the operational effectiveness of the FSCS. Certain operational challenges have been identified with the present regime, both from the continuity of cover and a payout perspective. These issues were discussed in the FSA's recent consultation paper – Financial Services Compensation Scheme: changes to the Compensation sourcebook (CP 12/7) – together with potential solutions, and include in particular:[3]

- a concern that policyholders may be unwilling to pay premiums at 100 per cent when FSCS protection is 90 per cent, and may either stop paying premiums or surrender their policies, without considering the consequences (such as loss of benefits). In its consultation paper, the FSA discussed the possibility of increasing FSCS protection from 90 per cent to 100 per cent for benefits attributable to life insurance premiums, paid after the appointment of a liquidator/administrator, until the FSCS secures continuity or pays compensation; and
- a potential risk that, in the event of failure, payments to policyholders may cease (potentially for up to 24 months) while the failed firm's systems are changed to enable payment to be made at 90 per cent. This is a particularly important challenge for annuity holders, whose payment of income could be interrupted. One way to address this could be to enable the FSCS to fund benefits payable in the form of income (e.g. pension annuities) at 100 per cent until systems can be changed.

5.21 The FSA consultation paper does not propose new rules or guidance, but the FSA is currently reviewing responses to the consultation (which closed on 26 June 2012) and considering what action it might take in these areas.

The case for a new resolution regime for insurers

5.22 The FSB's Key Attributes require resolution regimes to be in place to deal with any financial institution whose failure could be systemic, including insurers. Building on the FSB work, the IAIS is undertaking work to consider how the FSB's Key Attributes should be applied to insurers, but the IAIS has already stated that "specific insurance resolution tools such as portfolio transfer and run-off are prime mechanisms to ensure continuation of insurance contracts in the context of the resolution of an insurance legal entity and a group".

5.23 In Europe, the European Commission has committed to publishing a consultation paper on arrangements for resolving failing non-bank institutions, including insurers, later in 2012, with legislation potentially following at a later date.

5.24 Some countries have moved ahead of the international work and have developed resolution regimes for insurers. In Europe, the Netherlands has recently passed legislation introducing resolution tools to cover the failure of banks and insurance firms. In Australia, the regime also includes similar resolution powers for banks, general insurers and life insurers.

5.25 It is sensible therefore to consider whether, in addition to strengthened insolvency procedures, the UK authorities should introduce a resolution regime for insurance firms that includes a set of stabilisation powers to permit the orderly resolution of any insurance firm that could be systemically significant if it fails. An argument in favour is that the constant evolution

[3] Financial Services Authority, 2012, *Financial Services Compensation Scheme: changes to the Compensation sourcebook (CP12/07)*: http://www.fsa.gov.uk/static/pubs/cp/cp12-07.pdf

of the financial sector, its strong interconnections and the fact that systemic risk can be context specific, could point towards providing the UK authorities with a wider range of resolution powers and options to respond to insurer failure. On the other hand, it could be argued that the risks posed by insurer failure could be addressed more appropriately by other means, and that the uncertain systemic risk of failure does not warrant a standing resolution regime.

5.26 Under such an approach, the UK authorities would determine whether the public interest condition for exercising a stabilisation power was met by assessing the likely systemic consequences of failure in the run-up to an insurer failure. If the public interest test were met, stabilisation tools would be available; if not, a modified insolvency procedure would be used. Possible stabilisation tools could take a similar form to those used in the SRR for deposit-takers. In exploring an SRR for insurers, the objectives, triggers for intervention and appropriate safeguards would need to be carefully considered.

New preventative supervisory tool

5.27 In addition to the above, there may be supervisory tools that would be useful in dealing with a failing insurer. The IAIS report 'Issues paper on resolution of cross-border insurance legal entities and groups' outlines that some jurisdictions have a portfolio transfer tool, which enables an insurer to move all or certain of its insurance business to another insurer without the consent of each and every policyholder, subject to approval by the regulatory authorities and other interested parties. Such transfers may, in full or in part, allow the maintenance of insurance contracts beyond insolvency and therefore safeguard the interests of the policyholders to a maximum.[4]

5.28 In the UK, assets and liabilities can currently be transferred from one insurer to a third party under Part VII of the FSMA. For friendly societies, a portfolio transfer power exists providing the regulator with the ability to direct the transfer of an insurance portfolio from a failing insurer to a recipient insurer.[5] Transferring existing insurance liabilities to another insurer is a bespoke and natural way of ensuring that the interests of the policyholders of the failing firm are protected and that continuity of cover is preserved where there is a willing purchaser. There are conceivable cases when a transfer of business from a failing or failed insurer to an insurer that is a going concern will provide for a better outcome for policyholders than any of the other alternatives.

5.29 If such a tool were to be developed for the insurance sector, it could provide the regulator with the power to direct a transfer, utilise the Part VII framework and potentially be used as a preventative supervisory tool, i.e. used pre-insolvency subject to appropriate safeguards.

Summary of Government's position

5.30 Insurers are a key part of the UK, European and international financial system and the Government wants to ensure that all failing insurers can exit the market without disorderly impact and achieve an appropriate degree of policyholder protection including, where appropriate, through continuity of cover for policyholders. At a minimum, this suggests reviewing the current insolvency framework to ensure it provides insolvency practitioners with the tools to manage a firm's failure in a way that secures appropriate continuity of cover for policyholders.

5.31 The Government does not have a firm view on the appropriateness of introducing a comprehensive resolution regime for insurers to respond to systemic risk and would welcome views on these powers and whether it would be sensible to future-proof the regulatory framework in this way.

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[4] International Association of Insurance Supervisors, 2011, *Issues paper on resolution of cross-border insurance legal entities and groups*: http://www.iaisweb.org/__temp/Issues_paper_on_resolution_of_cross-border_insurance_legal_entities_and_groups.pdf

[5] As set out in section 90 of the Friendly Societies Act 1992.

Consultation questions

- Do you consider that some insurance institutions have a degree of systemic potential?
- Do you agree with the Government's overarching objectives that any insurer should be able to exit the market without disorderly impact, and that the interests of policyholders should be appropriately protected? If so, what is the most appropriate means of achieving these objectives?
- Do you consider that the insolvency framework for dealing with the failure of insurers needs to be enhanced? What form should improvements take to provide greater clarity and certainty around securing continuity of cover for policyholders?
- Do you consider that the UK authorities should have resolution tools in the event that the failure of an insurance company raises public interest concerns because it is likely to have systemic implications?
- Do you consider that a portfolio transfer power should be introduced for use as a preventative supervisory tool?

A Impact assessment

A.1 The following pages contain the impact assessment for this document.

Title: Financial sector resolution: broadening the regime **IA No:** HMT1202 **Lead department or agency:** HM Treasury **Other departments or agencies:** N/A	**Impact Assessment (IA)** **Date:** 17/07/2012 **Stage:** Consultation **Source of intervention:** Domestic **Type of measure:** Primary legislation **Contact for enquiries:** Mohammad Zayyad, HM Treasury, 0207 270 4837
Summary: Intervention and Options	**RPC Opinion:** Awaiting Scrutiny

Cost of Preferred (or more likely) Option

Total Net Present Value	Business Net Present Value	Net cost to business per year (EANCB on 2009 prices)	In scope of One-In, One-Out?	Measure qualifies as
N/A	N/A	N/A	No	NA

What is the problem under consideration? Why is government intervention necessary?

Similar to banks, non-bank financial institutions are a very significant part of the financial system and can also be systemically important. The UK currently has no way to resolve these institutions in an orderly manner, meaning that their failure could generate significant costs on the economy. Government intervention may therefore be necessary to mitigate the potential for such costs to materialise. Given that the benefit of taking action to introduce such a formal resolution regime would always be expected to exceed the costs of disorderly failure, the UK Government believes that there is a strong value for money case for introducing stabilisation powers to resolve (at least some of) these institutions and to do so according to an earlier timeframe than the UK Government is expecting to be delivered through EU legislation.

What are the policy objectives and the intended effects?

The proposals being consulted on are intended to protect financial stability. Its objectives are:

- Strengthening the stability and resilience of the financial system by preventing contagion and maintaining market discipline;
- Reducing the likelihood of individual firms threatening the wider stability of the UK if they get into difficulties;
- Ensuring the continuity of critical market functions; and
- Protecting depositors, client funds and client assets.

What policy options have been considered, including any alternatives to regulation? Please justify preferred option (further details in Evidence Base)

The two broad options being considered by the Government to address the risks to stability posed by the failure of non-bank financial institutions are to:

- Do nothing: The UK Government relying on expected European-led process to introduce any necessary regimes and supporting stabilisation tools; and
- The UK Government taking action to introduce, via domestic legislation, necessary regimes and supporting stabilisation options sooner than any European timetable will provide.

Will the policy be reviewed? It will not be reviewed. **If applicable, set review date:** Month/Year

Does implementation go beyond minimum EU requirements?			N/A		
Are any of these organisations in scope? If Micros not exempted set out reason in Evidence Base.	**Micro** No	**< 20** No	**Small** No	**Medium** Yes	**Large** Yes
What is the CO_2 equivalent change in greenhouse gas emissions? (Million tonnes CO_2 equivalent)			**Traded:** N/A	**Non-traded:** N/A	

I have read the Impact Assessment and I am satisfied that, given the available evidence, it represents a reasonable view of the likely costs, benefits and impact of the leading options.

Signed by the responsible SELECT SIGNATORY: Mr MM Date: 18/07/2012

Summary: Analysis & Evidence — Policy Option 1

Description: The UK Government relying on expected European-led process to introduce any necessary regimes and supporting stabilisation tools.

FULL ECONOMIC ASSESSMENT

Price Base Year N/A	PV Base Year N/A	Time Period Years N/A	Net Benefit (Present Value (PV)) (£m)		
			Low: Optional	**High:** Optional	**Best Estimate:** N/A

COSTS (£m)	Total Transition (Constant Price) Years		Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low	N/A		N/A	**N/A**
High	N/A		N/A	**N/A**
Best Estimate	N/A		N/A	**N/A**

Description and scale of key monetised costs by 'main affected groups'

Most of the costs on the main affected groups arising as a result of reforms introduced via a European process will be difficult to monetise or will be non-monetisable. In these instances, a qualitative assessment is made of their likely impact.

Other key non-monetised costs by 'main affected groups'

All of the costs of action via a European process are non-monetised. This is because the anticipated costs are contingent on the failure and resolution of a non-bank institution which is unprededented. Even in the event of failure, these costs would vary significantly depending on the circumstances. Further details of the key costs to the main affected groups from this option are outlined in the evidence base.

BENEFITS (£m)	Total Transition (Constant Price) Years		Average Annual (excl. Transition) (Constant Price)	Total Benefit (Present Value)
Low	N/A		N/A	**N/A**
High	N/A		N/A	**N/A**
Best Estimate				

Description and scale of key monetised benefits by 'main affected groups'

Most of the benefits to the main affected groups arising as a result of the proposed reforms will be difficult to monetise or will be non-monetisable. In these instances, a qualitative assessment is made of their likely impact.

Other key non-monetised benefits by 'main affected groups'

All of the benefits of action via a European process are non-monetised. The benefits from having resolution regimes in place for non-bank institutions earlier than any expected European process arise mainly as a result of the increased confidence regarding the stability of the UK financial system in addition to the associated reduction in the likelihood and impact of any non-bank failure. Further details of the key benefits to the main affected groups from this option are outlined in the evidence base.

Key assumptions/sensitivities/risks — **Discount rate (%)** N/A

N/A

BUSINESS ASSESSMENT (Option 1)

Direct impact on business (Equivalent Annual) £m:			In scope of OIOO?	Measure qualifies as
Costs: N/A	**Benefits:** N/A	**Net:** N/A	No	NA

Summary: Analysis & Evidence — Policy Option 2

Description: The UK Government taking action to introduce, via domestic legislation, necessary regimes and supporting stabilisation options sooner than any European timetable will provide.

FULL ECONOMIC ASSESSMENT

Price Base Year	PV Base Year	Time Period Years	Net Benefit (Present Value (PV)) (£m)		
N/A	N/A	N/A	**Low:** Optional	**High:** Optional	**Best Estimate:** N/A

COSTS (£m)	**Total** (Constant Price)	**Transition** Years	**Average Annual** (excl. Transition) (Constant Price)	**Total Cost** (Present Value)
Low	N/A		N/A	**N/A**
High	N/A		N/A	**N/A**
Best Estimate	N/A		N/A	**N/A**

Description and scale of key monetised costs by 'main affected groups'

Most of the costs on the main affected groups arising as a result of action will be difficult to monetise or will be non-monetisable. In these instances, a qualitative assessment is made of their likely impact.

Other key non-monetised costs by 'main affected groups'

Most of the costs of taking action are non-monetised. This is because the anticipated costs are contingent on the failure and resolution of a non-bank institution which is unprededented. Even in the event of failure, these costs would vary significantly depending on the circumstances. Further details of the key costs to the main affected groups are outlined in the evidence base.

BENEFITS (£m)	**Total** (Constant Price)	**Transition** Years	**Average Annual** (excl. Transition) (Constant Price)	**Total Benefit** (Present Value)
Low	N/A		N/A	**N/A**
High	N/A		N/A	**N/A**
Best Estimate				

Description and scale of key monetised benefits by 'main affected groups'

Most of the benefits to the main affected groups arising as a result of taking action will be difficult to monetise or will be non-monetisable. In these instances, a qualitative assessment is made of their likely impact.

Other key non-monetised benefits by 'main affected groups'

All of the benefits of taking action are non-monetised. The benefits from having resolution regimes in place for non-bank institutions earlier than any expected European process arise mainly as a result of the increased confidence regarding the stability of the UK financial system in addition to the associated reduction in the likelihood and impact of any non-bank failure. Further details of the key benefits to the main affected groups are outlined in the evidence base.

Key assumptions/sensitivities/risks — **Discount rate (%)** N/A

N/A

BUSINESS ASSESSMENT (Option 2)

Direct impact on business (Equivalent Annual) £m:			In scope of OIOO?	Measure qualifies as
Costs: N/A	**Benefits:** N/A	**Net:** N/A	No	NA

Introduction

Assessing the impact of the Government's proposals

1. The consultation document discusses proposals for managing the risk to financial stability presented by the failure of systemically-important non-banks. The document considers the case for addressing this risk through domestic legislation where necessary and on a more accelerated timetable than expected as part of any European process.
2. This consultation stage impact assessment sets out the case for Government action, the proposals being considered and an analysis of the costs, benefits and likely impacts of possible reforms.

Scope

3. Only the options and proposals relating to the resolution of systemic investment firms, parent undertakings and central counterparties (CCPs) are included in this impact assessment. The Government welcomes views on the likely impact of these measures, which will support further development of these policy approaches and preparing any necessary future iterations of the cost-benefit analysis.
4. The consultation document does not present proposals for a comprehensive resolution regime for insurers and financial market infrastructure (excluding central counterparties). As such, the consideration of costs and benefits within this impact assessment does not extend to these firms.
5. For insurers, although the document acknowledges the likelihood of such institutions having some degree of systemic potential, the Government does not have a firm view on the appropriateness of introducing a comprehensive resolution regime to respond to systemic risk. In particular, the consultation document highlights the concerns that the Government has with the current resolution framework specifically around the insurance liquidation and administration processes and suggests possible options for strengthening these regimes.
6. For financial market infrastructure (excluding central counterparties), the Government does not have a firm view on the appropriateness of introducing a comprehensive resolution regime to respond to systemic risk. Instead, it sets out a series of questions to help the Government to understand the situations in which these firms could be considered to be systemic and invites reaction as to the appropriate policy response.

Process going forward

7. An implementation stage impact assessment will be published post consultation, taking into account policy development occurring in the light of this consultation. In particular, the next version of this impact assessment will consider the costs and benefits of any settled proposals for insurers and financial market infrastructure (excluding central counterparties) following this consultation.
8. Accordingly, contributions are now sought that may improve the analysis of the benefits, costs and risks arising from the reforms currently proposed.

Terminology

9. The costs and benefits identified for the policy proposals under consideration are classified as being either direct or indirect. In the context of the proposals being considered by the Government, direct costs and benefits are those that will be experienced regardless of whether the powers being proposed are used to resolve a systemic non-bank firm. Indirect costs and benefits on the other hand will only occur in the event of the proposed powers being exercised.
10. Irrespective of whether costs and benefits are direct or indirect, their impact will also either be monetisable or non-monetisable. Monetisable costs and benefits are those that, given the current evidence, the Government is able to estimate. As we highlight in later sections, a lot of the costs and benefits, whether direct or indirect, arising as a result of the proposed reforms will be difficult to

monetise or will be non-monetisable. In these instances, a qualitative assessment is made of their likely impact.

11. Monetisation is difficult mainly because systemic non-bank failure and in turn intervention by the Government to resolve such institutions is unprecedented, making it difficult to accurately put a figure on its likely impacts. Although parallels can be drawn from the failure of deposit taking banks, some of the non-bank institutions under scope (investment firms, parent undertakings and central counterparties) are fundamentally different in their structure and operation meaning that any such comparative assessments would be potentially spurious.
12. Nevertheless, the Government will continue to attempt to monetise estimates of these impacts, where feasible, over the course of the consultation period.

Structure of Impact Assessment

13. The summary sheet for this impact assessment presents the Government's proposals, the policy options considered and an economic assessment of these options. In line with impact assessment guidance, the cover sheet only contains the non-monetisable benefits and costs for the proposals put forward by the Government as monetary estimation at this stage is not feasible. As such, the analysis of the costs and benefits are presented alongside the discussion of the proposals.
14. However, the Government anticipates that for some of the proposals put forward, it may be feasible to estimate their monetary impact following the analysis of evidence gathered over the consultation period. The Government welcomes any information in support of these estimations.
15. The Evidence Base for the impact assessment is structured as follows:
    1. Rationale for action by the Government
    2. Policy objectives
    3. Policy options considered
    4. Analysis of policy options
    5. Overview of proposed resolution tools
    6. Costs and benefits of resolving a systemic non-bank
    7. Wider impacts

Rationale for action by the Government

16. The 2007-09 financial crisis exposed a great many flaws in the global financial system. In particular, systemically important banks, when they ran into trouble, could not be allowed to collapse in a disorderly way, because of the damage this would have done to the financial system and the wider economy. With no alternatives, the taxpayer was forced to step in and bail-out failing banks.
17. To address the problems, a wide-ranging programme of banking and wider financial sector reform is underway at European and global level. The UK is actively engaged in this and is also taking action domestically. When it came into office, the Government asked the Independent Commission on Banking to recommend ways to strengthen the resilience of the banking system and promote competition.
18. In June, the Government published a white paper setting out how it would implement those recommendations. The UK also already has in place a special resolution regime (SRR) for banks, as well as enhanced capital and liquidity regimes. Collectively, these reforms seek to ensure that banks are better able to cope with shocks in the future and that, if banks do fail, they can be resolved safely without risk to the taxpayer or to financial stability.
19. But banks are only part of the financial system. Other types of financial institutions can also pose a risk to financial stability, if there is no way for them to fail safely. The disorderly failure of financial market infrastructures (FMIs) – systems that connect market participants to each other – could also severely disrupt both financial markets and the normal functioning of the wider economy.

20. The potential economic cost of allowing systemically important non-bank financial institutions or FMIs to collapse means that they too may need taxpayer support should they run into trouble, if there is no way for them to fail safely. For example, in the recent crisis, the US authorities provided taxpayer-funded support to bail out Bear Stearns (an investment firm), AIG (an insurer) and also to underpin money market funds.

21. Because of these risks, in its banking reform white paper, the Government undertook to explore the case for addressing gaps in the resolution regime framework for non-banks on a more accelerated timetable than that currently envisaged in ongoing international work.

22. The Government is therefore consulting on proposals and questions on enhancing the mechanisms available for dealing with the failure of systemically-important non-banks. In taking forward these proposals, an important consideration will be whether the best response might be extending and/or strengthening existing administration/run-off arrangements as opposed to introducing a new, comprehensive resolution regime. A balance needs to be struck between enhancing financial stability, and ensuring that the regulatory regime is not unnecessarily complex or burdensome (for the authorities, and industry).

Policy objectives

23. The Government's overall rationale for acting is to protect financial stability by ensuring a robust regime, supported by stabilisation tools, is in place for managing the failure, or likely failure, of any non-bank financial institution with the potential to be systemic. The options and proposals set out in the consultation document are targeted at achieving this in line with the following objectives:

    - Strengthening the stability and resilience of the financial system by preventing contagion and maintaining market discipline;
    - Reducing the likelihood of individual firms threatening the wider stability of the UK if they get into difficulties;
    - Ensuring the continuity of critical market functions; and
    - Protecting depositors, client funds and client assets.

24. The Government will be seeking to achieve the above objectives whilst also ensuring that;

    - Taxpayer interests are protected; and
    - The interference with rights in contravention of a right within the meaning of the Human Rights Act 1998 is avoided in so far as is reasonably possible.

Sectors and firms affected

25. The proposals presented in the consultation document are expected to affect (either directly or indirectly) the following groups:

    - Investment firms (and their parent undertakings) incorporated in the UK;
    - Parent undertakings of deposit taking financial institutions already captured by the Banking Act 2009;
    - Central counterparties (CCPs) which offer central counterparty clearing services – there are four recognised CCPs in the UK[1];
    - The financial authorities – HM Treasury, the Bank of England and the Financial Services Authority (FSA); and
    - Wider financial and non-financial industry – this includes customers/clients, shareholders, counterparties and administrators.

[1] In addition to two more seeking recognised clearing house status in the UK.

26. As set out in the consultation document, the financial authorities would only consider acting to resolve a failing, or likely to fail, financial institution incorporated in the UK if its failure posed a threat to the UK's wider financial stability or taxpayer interests. Such firms are typically classified as posing a 'systemic' risk and only a small number of firms within each of the above groups would be considered to be systemic or have the potential to be systemic.

27. For this reason the direct and indirect impact of the options set out in the consultation document will mainly only significantly affect a minority of firms in the groups listed above, although, as set out in following sections there are industry-wide costs and benefits associated with acting.

Impact on micro businesses

28. Given the interconnected nature of the financial services sector and its importance to the wider economy, the proposals being consulted on have the potential to impact on micro firms[2] in the following ways:
    - As consumers of the services provided by the firms under scope; and
    - As providers of non-bank services.

29. However, these proposals are out of scope of the moratorium on new regulations for micro-businesses. As consumers, there will be no impact because, in the event of resolution action being taken, micro firms would have the same rights as other shareholders and creditors.

30. As providers, there will be no impact on micro firms because resolution action will only be taken to prevent the disorderly failure of firms which are considered to be systemic (and micro firms are unlikely to be systemic, although what is "systemic" varies depending, among other things, on market conditions).

31. Before any of the proposals are introduced, the Government is committed to ensuring that regulation is proportionate and the proposals will not have a disproportionate impact on small firms. The Government therefore welcomes any further information regarding the potential impact of the proposals contained in the consultation document on small firms.

Policy options considered

32. The two broad options open to the Government to address the risks to stability posed by the failure of non-bank financial institutions are to:
    - Do nothing: The UK Government relying on expected European-led process to introduce any necessary regimes and supporting stabilisation tools; and
    - The UK Government taking action to introduce, via domestic legislation, necessary regimes and supporting stabilisation options sooner than any European timetable will provide.

33. Each option is discussed in further detail below.

Do nothing option

34. The Financial Stability Board (FSB) published the Key Attributes of Effective Resolution Regimes for Financial Institutions in November 2011 which set out the responsibilities and powers that national resolution regimes should have to resolve a failing systemically important financial institution (SIFI). More specifically, the Key Attributes recommend jurisdictions to:
    - Ensure resolution authorities have a broad range of powers to intervene and resolve a financial institution that is no longer viable;
    - Remove impediments to cross-border cooperation;
    - Ensure that recovery and resolution plans are put in place for all global SIFIs; and

[2] Micro-businesses contain fewer than 10 employees.

- Maintain Crisis Management groups for all global SIFIs.

35. The UK has a long term commitment, along with other G20 countries, to implement the Key Attributes for Effective Resolution Regimes published by the FSB. This includes introducing resolution regimes for any type of financial firm with the potential for causing a systemic impact in the event of failure – including holding companies, investment firms, insurance companies and FMIs.

36. Further to the Key Attributes, the UK Government expects the European process to introduce resolution regimes for each of the non-bank financial institutions under consideration in due course but according to different timetables.

37. Details of the European Commission's plans for each type of non-bank institution under scope are discussed in turn below.

Investment firms and parent undertakings

38. The European Commission's proposed RRD would require Member States to introduce resolution regimes for deposit takers and investment firms and their parent undertakings. The proposal covers 3 broad areas: preparation and prevention, early intervention, and resolution[3]. It also covers provisions on cross-border cooperation and resolution financing. The proposed stabilisation tools to be included in the RRD include:

    - A sale of business tool whereby the resolution authority would sell all or part of the failing firm to a private sector purchaser;
    - The bridge tool which consists of identifying the good assets or essential functions of the failing firm and separating them into a new bridge entity which would eventually be sold to another entity. The failed firm with the bad or non-essential functions would then be placed into insolvency proceedings;
    - An asset separation tool, whereby the bad assets of the failing firm are put into an asset management vehicle. The tool may be used only in conjunction with another tool (bridge entity, sale of business or write-down). This ensures that while the failing firm receives support, it also undergoes a restructuring; and
    - A debt write-down tool ("bail-in") whereby the failing firm would be recapitalised with shareholdings wiped out or diluted, and relevant creditors having their claims reduced or converted to shares.

39. In terms of implementation, the Commission's published intention is that Member States will be required to transpose the framework by 1 January 2015. The bail-in tool, however, has a longer implementation timeframe and is expected to be implemented by 1 January 2018 at the latest.

Central counterparties

40. Following the publication of the FSB's Key Attributes, the FSB noted that not all resolution powers will be suitable for all sectors and all circumstances, and, in the context of Financial Market Infrastructure (FMI) (including CCPs), the choice of resolution powers should be guided by the need to maintain continuity of critical FMI functions.

41. As such, a joint Committee on Payment and Settlement Systems (CPSS) and International Organization of Securities Commissions (IOSCO) working group (henceforth CPSS-IOSCO) has – with the support of the FSB – been conducting work on the appropriateness of the FSB's Key Attributes for resolution regimes for financial market infrastructure. In particular, CPSS-IOSCO is considering the need for CCPs to introduce loss-sharing rules, and, whether specific resolution arrangements for FMIs are needed.

42. The UK expects that, in due course, the European Commission will propose measures to require Member States to introduce resolution regimes for CCPs in line with, or closely following,

[3] The consultation document only includes proposals relating to the resolution elements of the RRD.

recommendations to be set out by CPSS-IOSCO[4]. The tools likely to be incorporated into any European legislation covering resolution powers for central counterparties include:

- Transfer powers enabling the transfer of ownership and or some/all of the assets, rights and liabilities or securities of a failed FMI (subject to a number of conditions) to either a private sector purchaser or a bridge entity;
- Loss allocation rules, or similar powers for imposing losses, to effect the allocation of losses among participants to prevent the failure of the FMI;
- A moratorium preventing outgoing payments from a FMI and a stay on creditor actions to attach assets or otherwise collect money or property from the entity which is under resolution; and
- A "bail-in" power to enable Government to write down or convert unsecured and uninsured claims with a view to maintaining critical operations and services of a FMI.

43. However, the timetable for any future EU legislative action is unclear, and the UK Government does not expect that powers to resolve a central counterparty will be made available through the European process for a number of years.

Insurers

44. The Key Attributes of effective resolution regimes also apply to insurers. The International Association of Insurance Supervisors (IAIS) is currently undertaking work to consider how the FSB Key Attributes should be applied to insurers.
45. The European Commission has also committed to look at the issue of resolution for the insurance sector. However, the timetable for planned Commission work is not yet firm.
46. As set out in the consultation document, the UK Government does not have a firm view on the appropriateness of introducing stabilisation powers for insurers at this stage.

Non-CCP Financial Market Infrastructure

47. Although the European Commission has indicated that further work covering these firms will be proposed, it is not yet clear whether that will lead to recommendations for resolution regimes at this stage.
48. Like insurers, the UK Government does not have a firm view on the appropriateness of introducing stabilisation powers for non-CCP financial market infrastructure at this stage.

Action option

49. As highlighted above, the expectation is that resolution powers for the non-bank financial institutions under consideration (systemic investment firms, parent undertakings and central counterparties) would be introduced at the European level eventually. However, this process is expected to take a number of years to conclude.
50. At this stage, the Government is proposing to legislate to introduce resolution tools for UK incorporated investment firms (and their parent undertakings) and central counterparties whilst investigating the instances in which insurers and other non-CCP financial market infrastructure can be considered to be systemic.
51. These powers are essential to address a situation where a systemic non-bank institution has encountered financial difficulties, enabling the authorities to resolve the failing firm in an orderly manner. The set of resolution tools that have been developed will provide the UK with additional protection against potential domestic and international threats to financial stability.

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[4] The findings of the CPSS-IOSCO working group which are due to be published in the summer of 2012.

52. An overview of the set of tools proposed as part of wider resolution regimes for investment firms (and their parent undertakings) and for central counterparties is summarised in table 1.A and 1.B below. As shown, whilst building on the Key Attributes, the set of tools proposed as part of the consultation differs in some cases to the tools the UK Government is expecting to be introduced as part of proposed European directives.

TABLE 1.A: OVERVIEW OF SUITE OF KEY RESOLUTION POWERS FOR INVESTMENT FIRMS AND THEIR PARENT UNDERTAKINGS

	DO NOTHING: EXPECTED EUROPEAN LED PROCESS	**ACTION BY UK GOVERNMENT**
Transfer powers to enable private sector purchaser	✓	✓
Transfer powers to enable a bridge bank	✓	✓
Transfer powers to enable TPO	×	✓
Asset transfer powers to an asset management vehicle/special purpose vehicle	✓	×
Debt write down (Bail-in)	✓	×
Modified insolvency and administration procedure	✓	×[5]
Temporary stay on rights to early termination of financial contracts	✓	×
Source: HM Treasury		

[5] Already exists in the UK in the form of the Special Administration Regime (SAR) and the Bank Insolvency Procedure (BIP).

TABLE 1.B: OVERVIEW OF SUITE OF KEY RESOLUTION POWERS FOR CENTRAL COUNTERPARTIES

	DO NOTHING: EXPECTED EUROPEAN LED PROCESS	ACTION BY UK GOVERNMENT
Transfer powers to enable private sector purchaser	✓	✓
Transfer powers to enable a bridge bank	✓	✓
Bail-in type power	✓	×
Moratorium preventing outgoing payments from a CCP	✓	×
Source: HM Treasury		

Analysis of policy options

53. The introduction of resolution tools for non-bank financial institutions will carry costs and benefits. It is important to make a distinction at this point between the costs and benefits of having a resolution regime for each of these types of firms and the costs and benefits of actually using the powers under these regimes to resolve failing firms (i.e. between direct and indirect costs and benefits).
54. Similar to the stabilisation tools available under the Banking Act 2009, costs and benefits will mainly arise once a firm has entered into the regime and would also depend on the particular tool used by the Government to resolve a failing firm. These contingent indirect costs and benefits will be different to any direct costs and benefits which are expected to be negligible.
55. The following section sets out a cost-benefit analysis of each of the policy options open to the Government.

Do nothing option

56. As mentioned above, the UK Government expects the European Commission to prepare legislative proposals to require the introduction of resolution regimes for systemic investment firms, parent undertakings and central counterparties in the long term. The UK will be required to transpose any directive into UK law.
57. Overall, given the fact that these tools will be used in limited circumstances once available and the fact that any new regimes introduced through a European process would not impose particular requirements on non-bank firms outside of their ordinary operation, there are few direct monetisable benefits associated with them.
58. However, having resolution regimes in place for systemic non-bank institutions would generate some non-monetisable direct benefits arising mainly from increased confidence regarding the future stability of the financial system as a result of the Government being able to effectively resolve these systemic firms should they encounter financial difficulty.
59. In terms of indirect benefits, using the powers to resolve a failing systemic firm (provided the powers are available at the point of failure) would provide benefits with respect to ensuring the continuity of the critical functions provided by systemic firms and averting the threat of failure causing wider

disruptions to the financial system. As such the probability and impact of firm failure as a result of having resolution regimes in place would be reduced. These benefits will mainly accrue to:

- Depositors, clients, shareholders and counterparties – regimes will ensure the continued provision of the critical service provided by the systemic firms;
- Government and taxpayers – regimes would reduce the economic and therefore fiscal impact of failure; and
- Wider non-financial industry – regimes would manage the orderly failure of a systemic firm, isolating risks and thereby minimising contagion.

60. These benefits are difficult to monetise at this stage. However, the costs of a financial crisis arising from the failure of a systemic firm would always be expected to exceed the cost of intervention by the authorities to prevent the failure of the firm and so a wider crisis. By definition, as otherwise, it would not be considered as systemic.

61. Under this option however, uncertainty regarding the timeline for the introduction of resolution regimes as part of future EU legislative programmes means that the above benefits are conditional on the regimes actually being available. That is, if the regimes do not exist then there will be no benefits especially in the short term. This is where the case for domestic UK action arises.

62. Similar to the arguments above, there are no direct monetisable costs associated with having a set of resolution tools mandated by European measures.

63. However, there will be some non-monetisable indirect costs in the event of the resolution authority choosing to use powers to resolve one of the systemic firms under scope after it has experienced financial difficulty. These costs will mainly be administrative in nature. The affected groups include:

- Shareholders, creditors – these groups could incur losses in the event of resolution action being taken with respect to their investments in the failing firm;
- Clearing members – may incur costs and/or suffer losses as a result of the application of the resolution tools; and
- Customers – as they may lose access to the non-systemic services provided by these firms and may incur costs in finding alternative providers.

64. These costs would be difficult to monetise at this stage as some of them would depend on the particular circumstances. The section on the "costs of non-bank failure" provides a more detailed qualitative assessment of the impacts on key groups.

Action option

65. Absent European led action to provide powers to resolve systemically important investment firms, parent undertakings and central counterparties in the medium term, the alternative option would involve the UK Government taking action domestically to ensure that the relevant authority has the tools to ensure the orderly resolution of such firms.

66. This would involve taking legislative action to introduce resolution regimes for systemic non-bank financial institutions similar to the stabilisation tools available for deposit taking banks under the Banking Act 2009. In essence, each resolution regime for the different non-bank firms would encompass a set of tools which would enable the resolution authority to effectively resolve systemic firms were they to experience financial difficulty.

67. Similar to the do nothing option, there will be few monetisable direct benefits under this option but there will be non-monetisable direct benefits arising mainly from increased confidence regarding the future stability of the financial system as a result of the Government being able to effectively resolve these systemic firms should they encounter financial difficulty in the short term and before any formal European regimes are introduced.

68. There will be some indirect benefits under this option which again will be similar in nature to those under the do nothing option. The key difference from having resolution tools available within a faster time frame than a European led process will be that the indirect benefits to the key groups affected will accrue quicker than under the do nothing option.

69. These benefits would be difficult to monetise at this stage.
70. Similar to the do nothing option, there will be few monetisable direct costs under this option. However, there may be some direct non-monetisable costs for the Government from having to adapt any UK resolution regimes already introduced for non-bank financial institutions to comply with any future European directives introduced over the long term.
71. The indirect costs under this option would be similar to those under the do nothing option. However, taking action ahead of expected European action would mean that the indirect costs (highlighted above) would be brought forward and would impact on key groups earlier than what would have been the case through a European process introduced over the longer term if the powers, once in place, should be exercised.
72. These costs would be difficult to monetise at this stage as some of them would depend on the particular circumstances. The section on the "costs of non-bank failure" provides a more detailed qualitative assessment of the impacts on key groups.

Conclusions from options analysis

73. Given the analysis of both options described above, it is important to balance the merits provided by both options to reach a conclusion regarding the optimal course of action.
74. Over the long term, the introduction of resolution regimes in some form for the non-bank firms under consideration (given their potential to be systemic) as part of a European process is inevitable. As such, additional direct and indirect costs (as described in the option analysis above) will inevitably be incurred at the point when the respective Directives for each of the groups of firms under scope are eventually introduced and used to resolve a failing firm.
75. In effect, the consequence of domestic action by the UK government ahead of the respective European measures for each of the groups of firms under scope being introduced over the next few years is that these direct and indirect costs and benefits (given their similarity) will be brought forward and therefore incurred earlier than would otherwise have been the case.
76. However, although the costs of domestic action would be incurred earlier, the benefits of having resolution powers to resolve a systemic firm that would otherwise fail would also materialise earlier than would have been the case under a European led process. As mentioned above, this would reduce the likelihood and impact of any non-bank crisis and thereby protect and enhance financial stability.
77. Given that any resolution regime introduced as part of an expected European process or via domestic action will only be used in limited circumstances, it has already been established that the directly monetisable costs and benefits will be few. However, there will be indirect costs and benefits which are difficult to monetise at this stage.
78. From the point of view of costs, monetisation is difficult because unlike bank failures, the failure of a systemic non-bank firm is unprecedented. In the absence of a formal resolution regime, any intervention would most likely result in recourse to more complex and potentially contentious emergency powers, the costs of which could be very substantial. Similarly, doing nothing and allowing a systemic firm to fail would have an adverse impact on financial stability, the costs of which would be equally as large.
79. The benefit of taking action as part of a formal resolution regime, whilst also being difficult to monetise, would always be expected to exceed the costs of disorderly failure described above.
80. Given this, the UK Government believes that there is a strong value for money case for introducing powers earlier than is expected as part of any European process.

Overview of proposed resolution tools

Investment Firms and Parent Undertakings

Transfer Powers

81. The powers being proposed by the Government are intended to be similar to the stabilisation tools available under the Banking Act 2009. The powers would provide the resolution authority with the ability to transfer ownership and or some/all of the assets, rights and liabilities or securities of a failed investment firm (subject to a number of conditions) to either:

- A private sector purchaser;
- To a bridge entity wholly owned and operated by the Bank of England; or
- Temporary public ownership.

82. The power would ideally be used only to transfer the systemic elements of the institution (i.e. those providing a critical market function/at risk of presenting a systemic risk of contagion) but may require the transfer of the entire institution so as to ensure that its systemic functions are preserved.

Private Sector Purchaser

83. This tool would empower the resolution authority to transfer the business of a failing investment firm either by the transfer of the shares, or of its property, rights and liabilities, to a private sector purchaser who is willing to accept the transfer.

84. The resolution authority would only use this power in situations where the conditions for entering the resolution regime are met and there are sufficient public interest grounds for intervention.

Bridge Entity Tool

85. This tool would enable the resolution authority to facilitate the transfer of some of an investment firm's or parent undertaking's assets, rights and liabilities to another company (a 'bridge entity') with the aim of ensuring that the new 'good' entity can continue to provide investment services whilst the original 'bad' firm continues to exist albeit that it is wound down over time. This approach may reduce contagion risk by ensuring the continuing function of the services of the firm.

86. If the resolution authority decides that a bridge is the most appropriate resolution tool, it will establish a separate company and apply transfer powers to transfer property, rights and liabilities from the failing firm to the bridge. Following the transfer, the resolution authority will stabilise the business and once a suitable private sector purchaser has been found, the entity will be sold.

Temporary Public Ownership

87. This tool would empower HM Treasury to transfer the business of a failing investment firm or parent undertaking either by the transfer of the shares, or of its property, rights and liabilities, into temporary public ownership. This power would be available to the Government as a last resort.

88. It is worth noting that HM Treasury already has the power to transfer the parent undertaking of a deposit taking firm into temporary public ownership.

Central counterparties

Transfer Powers

89. These powers would be similar to the stabilisation powers proposed for investment firms above albeit that it is not envisaged that HM Treasury would have the power to transfer a clearing house into public ownership.

Enhanced Power of Direction over an CCP

90. Building on the existing powers of direction which the Financial Services Authority has under the Financial Services and Markets Act 2000 (FSMA 2000), this power would enable the regulator to

direct a CCP to take action (or to refrain from taking action) to address risks to its solvency (or indeed any other matter). Specifically, the direction could also be employed to require a CCP to make changes to its rules, or introduce emergency rules or require rules to be activated. The Government considers such a power necessary to ensure that the regulator is able to protect against action, or inaction, by a CCP that might precipitate its failure or undermine effective resolution action.

Power of Direction over an Administrator

91. This power is intended to provide the resolution authority with the ability to direct the administrator of a failed CCP (subject to certain conditions) to take action to address risks to financial stability. It could be used in conjunction with the transfer powers (as outlined above) to require the CCP to continue to provide services in support of an acquirer of some of the CCP's business (such as a bridge entity).

Insurers, non-CCP Financial Market Infrastructure and Shadow Banking Entities

92. The consultation document does not propose the introduction of stabilisation powers for insurers and non-CCP financial market infrastructure at this stage.

Costs and benefits of resolving a systemic non-bank

93. The proposals being put forward by the Government will help address the risks to financial stability from the disorderly failure of a systemically important non-bank financial institution. This will be achieved through the introduction of robust resolution regimes, supported by stabilisation tools, to help manage the failure, or likely failure, of any systemic non-bank financial institution. This section considers in more detail the costs and benefits of intervention on market participants and the wider economy against the counterfactual of insolvency. An analysis of costs and benefits on the following broad groups is considered:

- Investment firm clients
- Clearing members and shareholders
- Wider counterparties
- The financial authorities
- The wider economy

94. These costs and benefits and their impacts on the key groups would be similar under both of the policy options under consideration, the main difference been over the timing of when the powers are in place.

Investment firm clients

95. In the event of an investment firm encountering financial difficulties and going into insolvency, clients may suffer losses and may become creditors with a claim on the estate. Under certain circumstances, some clients may be eligible for compensation (up to a maximum value of £50,000) under the Financial Services Compensation Scheme (FSCS) which could mitigate some of the losses.

96. In addition to the above costs, clients would also lose access to the critical services provided by that firm such as brokerage and potentially clearing services (given that investment firms may be CCP members as well) as well in addition to other costs stemming from the impacts of the disorderly failure of the firm.

97. Resolution action on the other hand has the benefit of potentially preventing liquidation altogether depending on the resolution tool used and the circumstances in question. For example, clients transferred to a bridge bank or private sector purchaser should avoid losses and retain access to critical services. In cases where clients do still face costs despite resolution actions, intervention by the Government to ensure the continuity of the critical services being provided by that firm would preserve some value in the firm. This would be of benefit to clients as it would mean that the costs that they would otherwise have suffered under liquidation could be reduced as a result of intervention

98. Overall, resolution action would result in a more beneficial outcome for investment firm clients than would be the case in the event of insolvency.

Clearing members and shareholders

99. The failure of a CCP would impose costs in the form of losses to clearing members and the counterparties of the CCP. For clearing members, costs would take the form of losses from assets lodged with the CCP as part of margin contributions and contributions to the CCP's default fund. Similar to investment firm clients, members would also lose the use of the critical services provided by that CCP. The halt in trading whilst members' positions are being closed in addition to the process of finding and setting up with an alternative clearing provider would also generate further costs. Shareholders would also suffer costs due to the losses they would suffer in the value of their holdings with the firm.

100. Resolution action would have the benefit of ensuring the continuity of the services provided by the CCP (and therefore potentially avoiding a halt in trading). In addition, resolution action would preserve value in the CCP, the benefits of which may accrue to the shareholders in the long term. However, resolution action could also create some costs to clearing members and shareholders. The main costs to clearing members and shareholders from the use of such powers would be the interference in property rights or the deprivation of their rights to enjoy their property. However, compensation arrangements would be put in place following resolution action.

101. Moreover, the expanded power of direction for the regulator over CCPs which is being proposed may create uncertainties for firms in terms of the circumstances under which such a power would be invoked leading to additional costs. For instance, a requirement by the regulator for a CCP to take a certain course of action to protect its solvency such as accepting collateral only in cash for instance could create further costs for clearing members especially in periods of market uncertainty.

102. Nevertheless, as clearing members are the main users of the services provided by the CCP, ensuring continuity of service as a result of resolution action would save clearing members from potentially much greater costs and risks that they would otherwise incur in insolvency. As such, resolution would result in a more beneficial outcome for clearing members in comparison to insolvency on balance.

Wider counterparties

103. In the event of the failure of a systemic firm, the loss of market confidence and uncertainty may result in market participants defaulting on their obligations or choosing to exercise their early termination rights on contracts, imposing losses on other counterparties. By stabilising the market and restoring the failed firm to solvency, resolution action would ensure that confidence returns to the market over the long term, minimising the risks or opportunities that may exist for counterparties to impose losses on other market participants.

104. Aside from the costs imposed from other counterparties, the counterparties of the failed investment firm or CCP would also become creditors. In this instance, the level of costs which they suffer would depend on whether they are secured or non-secured creditors. As such, the level of funds which they recover from the failed firm would vary. The erosion of value from the disorderly failure of the firm could exacerbate the level of these costs.

105. The benefit of resolution action therefore is that some value would still be preserved in the firm. As such, creditors would be likely to recover a greater proportion of their costs than would have been the case in the event of full liquidation. This would particularly be the case in the event of certain resolution tools (partial property transfer powers) being used as safeguards would be made available to ensure that no creditor is worse off as a result of action than would have been the case under insolvency.

106. Overall, resolution action should result in a better outcome for creditors than would be the case under normal insolvency.

The financial authorities

107. Should a systemic firm go into insolvency, then there would be no direct costs to the financial authorities. However, in the absence of formal resolution action being taken, the Government could suffer costs as a result of the wider instability that the disorderly failure of the firm would create.

108. Resolution action would therefore have the benefit of minimising these costs by reducing the impact of failure on wider financial stability. Nevertheless, the authorities would incur costs from intervening to resolve the firm in question. These costs would primarily be operational and administrative in nature. For instance, the exercise of transfer powers by the resolution authority would result in costs (legal, financial and accounting) mainly from;

- Finding and dealing with potential private sector purchasers; and
- Ongoing operational costs from running a bridge firm or a firm that has been taken into temporary public ownership up until the time the bridge is sold on.

109. However, it may be the case that the Government would be able to recover some of the administrative costs it suffers from the pool of resources levied from the financial sector under the FSCS.

110. It is also possible that some of the resolution options proposed would also generate compensation costs where they result in interferences in property rights or the deprivation of property. These would be applicable in the event of the use of ancillary powers such as replacing management, varying terms of contracts and cancelling/deferring payments due on contracts.

111. On the whole, even where the Government incurs costs as a result of resolution action, the benefits of such action as part of a formal resolution regime would always be expected to exceed the costs of disorderly failure described above.

The wider economy

112. In the absence of a resolution regime for systemically important non-financial institutions, there would be costs to the wider economy in the event of such firms going into insolvency.

113. Given their size and importance, failure would result in the removal of the key service provided by that firm to its customers/clients/members. In a volatile market with uncertainty about the financial health of other financial institutions, there is a strong risk that the failure of a systemic firm would reduce the volume of trade in the market.

114. Moreover, the interconnected nature of modern financial markets and the financial exposures amongst market participants means that the effects of the collapse of a systemic firm can spread quickly and widely across markets, leading to contagion and resulting in a general loss of confidence within UK financial market as a whole. Resolution action would have the effect of restoring confidence thereby stabilising the impact of failure on the financial system.

115. In the long term and following resolution action, the UK financial sector would also bear some of the costs of compensating the customers/clients of any failed firm and potentially the authorities (indirectly) via the FSCS. However, in the case of non-bank financial institution failure, it would only apply to:

- Investment firms and their parent undertakings; and
- Insurance (general insurance, life insurance, advice on insurance products).

116. Nevertheless, the benefit of taking action as part of a formal resolution regime with regards to the impacts on the wider economy would always be expected to exceed the costs described above. Given this, the UK Government believes that there is a strong value for money case for introducing powers earlier than expected as part of any European process.

Wider impacts

One In One Out Policy

117. This policy is out of scope of the Governments One In One Out policy as it deals with systemic financial risk.

Equalities Impact

118. The Government considers that these proposals do not have a specific impact on racial equality.
119. The Government considers that these proposals do not have an impact on disability equality.
120. The Government considers that these proposals do not have an impact on gender equality.

Justice Impact

121. The Government considers that these proposals will not have an impact on the courts including claims on legal aid.

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If you require this information in another language, format or have general enquiries about HM Treasury and its work, contact:

Correspondence Team
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

Tel: 020 7270 5000
Fax: 020 7270 4861

E-mail: public.enquiries@hm-treasury.gov.uk

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