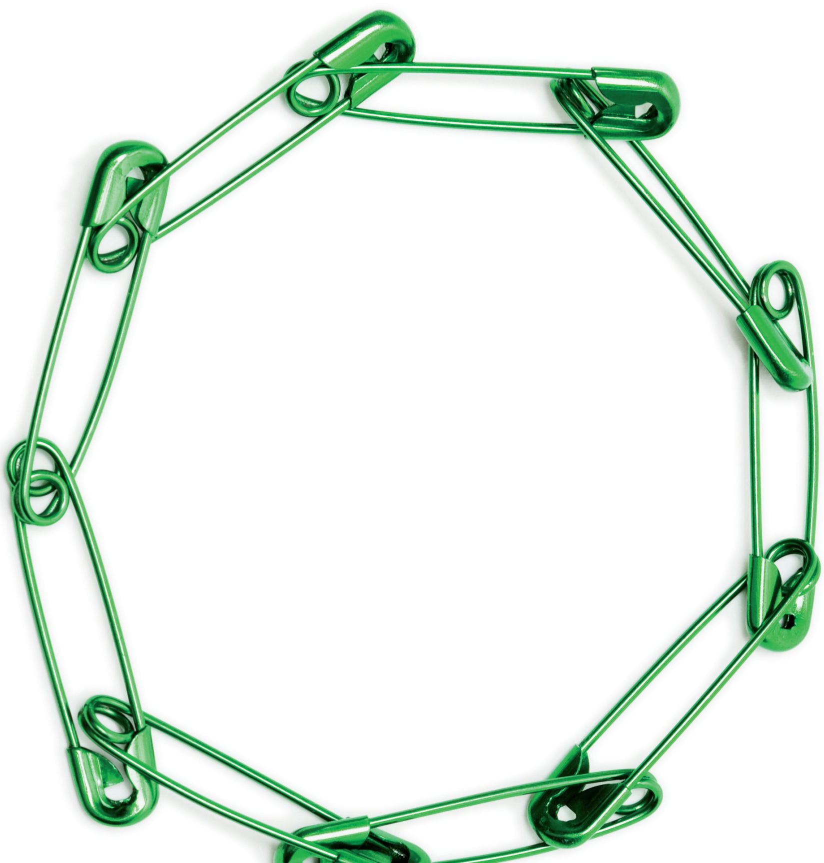
Financial Services

Recovery and resolution for non-banks
Building a safer financial system



EMEA Centre for Regulatory Strategy

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Introduction

Regulators are turning their attention to the potential risks non-bank financial institutions could pose to the financial system and the broader economy, and the regulatory solutions that should be applied to address those risks.

In this briefing, we provide an overview of the first European Commission (EC) consultation[1] on non-bank financial institutions (published October 2012) and outline the early regulatory thinking around the issue of recovery and resolution, first for financial market infrastructure (FMI), and then for insurers. Although the focus is on the EU, the briefing is set within the UK and international context.

Cross-sector recovery and resolution landscape

Recovery and resolution is one of several key international work streams aimed at addressing the risks posed by global systemically important financial institutions (G-SIFIs). The intention of a recovery and resolution framework is to reduce the likelihood of a G-SIFI failing in the event of financial distress through advanced planning and direct intervention by regulatory authorities. Globally, the regulatory focus to date has been on banks.

Recovery and resolution requirements for global systemically important banks (G-SIBs) are progressing. In the US, resolution planning rules have been finalised for insured deposit institutions. In the UK, final recovery and resolution planning (RRP) requirements for deposit takers and large investment firms are expected by end-2012. In addition, the EC has launched a proposal for a Recovery and Resolution Directive (RRD) for credit institutions and investment firms.

The need for RRPs for banks is broadly agreed. In contrast, the extent to which non-bank financial institutions contribute to systemic risk and, if so, how recovery and resolution regimes should be applied to various sectors remains a topic of debate. Regulators are now turning their attention to the potential risks non-bank financial institutions could pose to the financial system and broader economy, and the regulatory solutions that should be applied to address those risks. At present, the focus of discussion is largely centred on insurance firms and FMI.

The International Association of Insurance Supervisors (IAIS) is expected to finalise a methodology for identifying global systemically important insurers (G-SIIs), and a list of G-SIIs will be published by April 2013. Nevertheless the meaning of 'systemic risk' when applied to the insurance sector is likely to be a subject of debate well into 2013 and beyond.

All FMI, and in particular central counterparties (CCPs), are now assumed to be systemically important.[2] However, it is unlikely that all FMI firms will be subject to a full resolution regime.

In the US, the Financial Stability Oversight Council designated eight[3] financial market utilities (FMUs) as systemically important under Title VIII of the Dodd-Frank Act. Most of the identified FMUs provide clearing services, however a settlement system and a payment system have also been identified. All designated FMUs will need to meet recovery and resolution requirements, although it is not yet clear what the detailed provisions will entail. The Fed is expected to issue a notice confirming FMUs will be expected to self-assess by end-2013.

The EC consultation paper on recovery and resolution of FMI

The EC consultation paper sets out 30 open questions on the recovery and resolution of FMI and suggests several proposals for discussion. The EC is clear that only certain FMI[4] are being considered as part of the consultation process: CCPs and central security depositories (CSDs) that assume credit risk as principal. The emphasis of the consultation paper is, however, on CCPs. Areas of focus include scope, recovery and resolution objectives, tools and powers, and loss allocation as outlined in the table below:

EC FMI recovery and resolution consultation paper

Topic	Key areas of discussion
Scope of application	• The extent to which a recovery and resolution regime is appropriate for CCPs and the scenarios which may cause them to get into difficulty • The development of a methodology[5] (based on size, interconnectedness etc.) to identify systemically important CCPs • Imposing a CCP specific framework on top of bank RRP requirements for CCPs that are also credit institutions
Objectives	• Financial stability and the prevention of taxpayer bail-outs • The continuation of critical services, i.e. clearing and settlement in the case of CCPs
RRPs	• The split of roles and responsibilities in preparing and executing RRPs • Changes to contractual laws to allow ex-ante agreement on loss allocation between a CCP's members
Early intervention	• The appropriateness of early intervention measures • Allowing authorities to amend contractual arrangements or require a CCP to implement parts of its recovery plan
Resolution triggers	• Striking the balance between triggers which are flexible enough to enable authorities to resolve a CCP in a future crisis, yet also provide a degree of predictability for stakeholders
Resolution powers	• Identifying appropriate powers for CCP resolution authorities, using the powers proposed for bank resolution as the basis of discussion • A temporary stay on early termination rights and the power to impose a moratorium on payment-flows
Resolution tools	• The compatibility of resolution tools with existing national insolvency laws • The extent to which resolution tools available to resolution authorities should vary based on the cause of failure (e.g. clearing member default vs. commercial failure) • The suitability of **applying the resolution toolkit proposed for banks to CCPs**. Bank tools: sale of business, bridge institution, asset separation and bail-in. The EC's stated preference is to use the bridge institution tool and a modified version of 'bail-in'[6] which would include allocating uncovered losses[7] to an FMI's participants • **The bridge institution tool** involves the transfer of some of the FMI's critical services to a separate legal entity to be run by the authorities until a suitable buyer can be found. The remaining parts, left in the original entity, would be resolved independently • CCP bail-in approaches outlined: – **Haircuts to initial margin**: This may involve increasing the amount of initial margin clearing members must transfer to the CCP. The replenishment of initial margin could be smoothed over time to reduce procyclicality – **Haircuts to variation margin**: CCPs could use the variation margins of 'out of the money' participants rather than transferring them to the 'in the money participants' – The issuance of bail-inable debt which could be converted into equity on resolution • **Other loss allocating tools include:** – Specific **liquidity calls** on CCP members – **Resolution funds** which are built up on an ex-ante basis – **'Tear-up'** of contracts[8] – suggested as a last resort
Group level resolution	• The process of establishing cross border cooperation agreements between resolution authorities • The role of supervisory colleges • Centralising responsibility for resolving CCPs at the EU-level

How does the EC consultation compare with the international and UK approaches?

The emphasis of the EC paper is on CCPs, and to a lesser extent CSDs. The EC largely rules out resolution regimes for securities settlement systems (SSSs), payments systems, and trade repositories (TRs) – outlined as systemically important under the International Organisation of Securities Commissions' (IOSCO's) Principles for Financial Market Infrastructure (PFMI). The EC's approach is broadly consistent with the US approach where six of the eight FMUs designated as systemically important are CCPs. The EC approach is also consistent with the UK approach;[9] HM Treasury (HMT) has indicated that at present it will only pursue a full resolution regime for CCPs.[10] However, whilst the IOSCO consultation paper[11] on recovery and resolution of FMI is focused on CCPs, IOSCO considers a resolution regime for all FMI, including FMI that do not take on credit risk.

In terms of the detail, the EC paper differs from the international approach outlined in IOSCO's consultation paper in two ways:

- First, the EC considers 'tear-up' to be a last resort resolution tool, which should only be used when all other loss allocation tools have been exhausted. In comparison, tear-up forms a significant part of IOSCO's suggested approach to FMI 'recovery', and as such, would be implemented before resolution proceedings were triggered. In the past, industry has expressed concerns regarding the implications contract 'tear-up' could have for a clearing member's risk management, specifically the ability to hedge.

- Second, the EC paper does not provide details on how supervisory powers would work in practice. Conversely, IOSCO outlines several practicalities of implementing suggested powers and tools. For example, IOSCO proposes that CCPs introduce distinct margin and default fund arrangements per product type. This, IOSCO argues, would better facilitate the use of the bridge institution tool and, in particular, the separation of products which are causing losses for the CCP from non-affected products (akin to the form of a good bank/bad bank split).

A direct comparison between the EC consultation paper and the HMT consultation paper is problematic. HMT's consultation is focused on the legal framework for establishing a resolution regime for CCPs, and on extending the scope of the UK's Special Resolution Regime (SRR) to include CCPs. Nevertheless, where outlined, HMT's approach is broadly consistent with the EC's proposals. Interestingly HMT has also indicated that any additional loss allocation requirements for UK CCPs will need to be built into pre-existing operational rules and agreed on an ex-ante basis. However, it is worth noting that any legislation agreed at the EU level that goes above and beyond UK requirements will need to be incorporated into the UK resolution regime. In the UK, this could affect both the legal and insolvency frameworks.

Fundamental challenges for CCP resolution

At this early stage, a precise assessment of the EC proposal is difficult. However, a recovery and resolution regime could impose profound changes on CCPs, a CCP's clearing members, and to a lesser extent, the clients of clearing members.

Clarity and predictability of losses will be very important for any proposed FMI resolution regime – one of the reasons that central clearing is championed over bilateral risk management processes is that CCPs reduce counterparty risk and uncertainty and prevent contagion. The final CCP recovery and resolution regime must not increase uncertainty or contagion.

Key questions remain:

1. **To what extent should clearing members be forced to bear the cost of the default of another clearing member(s) beyond what has already been agreed in default waterfall arrangements?**
   Imposing additional losses on clearing members will be particularly controversial in the case where a clearing member is being asked to bear the cost of losses associated with products it does not trade and therefore does not clear. The issue of whether clearing members should pay the costs associated with the failure of a CCP due to fraud or operational risk is also highly controversial.

2. **Can a resolution process for CCPs be managed in a way which does not threaten the financial soundness of the CCP's clearing members?**
   A CCP in financial distress is unlikely to occur in isolation. Instead, it would likely occur at a time of market volatility; when the value of posted collateral had significantly declined; and, in the most severe circumstances one or more members had already defaulted. In such market conditions non-defaulting participants may also be in a weak position.

   Care would be needed when employing a CCP recovery or resolution approach in order to limit the impact on clearing members. If a result of maintaining the 'critical services' of a failing CCP is the failure of one or more clearing members who would otherwise have been financially viable, it could be argued that the CCP no longer fulfils its main objective of mitigating counterparty credit risk.

3. **What resolution powers would be appropriate for resolving a CCP?**
   The proposal for a temporary stay on early termination rights and a moratorium on payment-flows would prevent clearing members from actively managing their hedged and cash positions. This could have implications for risk management: firms unable to close out their positions may find themselves with large un-hedged exposures and unnecessarily subjected to swings in market prices. Potential risks at the individual firm level will need to be balanced against broader financial stability objectives. In addition, if it is decided that recovery and resolution measures for CCPs should be agreed on an ex-ante basis, how much flexibility will resolution authorities have in exercising powers?

4. **How will a resolution framework for CCPs fit within the national insolvency proceedings for CCPs and their counterparties?**
   CCPs have clearing members from a large number of countries. In order for a CCP resolution framework to be effective it must be effective in all the jurisdictions involved. Therefore national insolvency frameworks would need to be updated to accommodate a global resolution regime.

5. **Will CCPs that also hold a banking license be subject to the regime for banks or for FMI or both?**
   Regulators will need to consider:

   - The impact two different regimes would have on competition in the market.

   - Whether bank resolution requirements would be suitable for resolving a large CCP.

If a result of maintaining the 'critical services' of a failing CCP is the failure of one or more clearing members, it could be argued that the CCP no longer fulfils its main objective of mitigating counterparty credit risk.

The EC consultation paper on recovery and resolution of insurers

The EC consultation paper sets out 15 open questions on the recovery and resolution of insurers and suggests some proposals for discussion. The EC has been clear that any proposed requirements would only be applicable to systemically relevant insurers but does not define such firms (i.e. would the EC apply the requirements to identified G-SIIs, or more broadly).

Against this backdrop, the IAIS is in the process of finalising a methodology for identifying G-SIIs, which will be published alongside a list of designated firms in April 2013. And at the UK level, HMT has indicated that further consideration is needed before applying a full resolution regime to insurers.

Areas of focus for the EC include recovery and resolution objectives, tools and powers, specifically harmonising existing tools available in some European countries across the whole of the EU, as outlined in the table below:

EC insurance recovery and resolution consultation paper

Topic	Key areas of discussion
Harmonisation of existing resolution powers and tools	• Whether the **harmonisation of existing early intervention measures and resolution tools** across EU Member States would be sufficient for recovery and resolution purposes. Existing powers: imposing additional capital requirements and banning certain activities. Existing **resolution tools: run off, portfolio transfer, insurance guarantee schemes, bridge institution, restructuring liabilities and compulsory winding up**[12]
Objectives	• Financial stability and the prevention of taxpayer bail-outs • The continuation of critical services; continuity of policyholder protection in the case of systemic insurers
RRPs	• The split of roles and responsibilities in preparing and executing RRPs
Resolution triggers	• Timing of trigger i.e. resolution requirements should only be triggered in the event that all other intervention measures have been exhausted and winding-up under normal insolvency proceedings is considered a risk to financial stability or the real economy • Striking the balance between triggers which are flexible enough to enable authorities to resolve an insurer in a future crisis, yet also provide a degree of predictability for stakeholders
Additional resolution powers	• Identifying appropriate powers for insurance resolution authorities, using the powers proposed for bank resolution as the basis of discussion
Additional resolution tools	• **Structural intervention** i.e. ex-post **separation of systemically important non-traditional, non-insurance activities** (such as the writing of credit default swaps) from traditional activities. This is more easily achieved when systemically important business is carried out in a separate legal entity • **'Bail-in'**, which would involve recapitalising the insurer by converting debt claims owed to creditors into equity[13].
Group level resolution	• The process of establishing cross border cooperation agreements between resolution authorities • The role of supervisory colleges • Centralising responsibility for resolving insurers at the EU-level • **Whether resolution tools should be applied at a group or an entity level** • Whether supervisors should impose **prior authorisation of intra-group transactions as an early intervention measure**

How does the EC consultation compare with the UK and international approaches?

At an international level, the development of concrete proposals to identify and address the systemic impact of insurers is less advanced than that of banks or even FMI. Indeed, it is still an open question as to whether, and if so how, insurers pose systemic risk.

In the EU and the UK, the scope of discussion has been broadened from a focus on systemic risk in financial markets to considerations about the impact a disorderly failure of an insurer could have on specific segments of the real economy. In the UK, the debate has been extended to the specific topic of policyholder protection in general, with particular focus on continuity of insurance cover.

Methods to address the risks posed by insurers vary by jurisdiction:

- **HMT** has signalled its intention to extend and strengthen the UK's existing administration and run-off arrangements, rather than to introduce a full resolution regime at this point in time. In addition, the future Prudential Regulation Authority (PRA) is still considering whether, and if so how, to introduce RRP requirements for insurers.[14] Nevertheless, under the Proactive Indication Framework (PIF), RRPs will be required for insurance firms that reach 'stage three' or beyond (i.e. significant threats to an insurer's viability or policyholder protection have been identified).[15] In addition, the PRA will carry out resolvability assessments on all insurance firms; insurers will be expected to provide the PRA with information such as group structure, intra-group risk management and re-insurance arrangements.

- **The EC** is considering the harmonisation of existing early intervention measures and resolution tools across the EU; the introduction of RRPs, and additional resolution powers and tools in line with those proposed for banks.

- **Internationally**: if adopted, the IAIS proposals[16] will require G-SIIs to comply with the international recovery and resolution standards set out for G-SIFIs by the FSB.[17] IAIS has also suggested additional policy measures to address G-SIIs including a separate legal structure for traditional and non-traditional/ non-insurance (NTNI) business lines. In the EU, non-insurance business is already required to be held in a separate legal entity, however non-traditional insurance is not.

Depending on the final shape of global and EC proposals, significant change to UK legislation and regulation may be required. G-SII designation of a UK insurance firm may also require a revisit of the proposed HMT and PRA approaches.

Insurers and systemic risk

There has been much controversy over whether or not insurance firms pose systemic risk. The IAIS[18] has been clear in its view that traditional insurance businesses do not, highlighting the key differences between traditional insurance and banking activity:

- The performance of insurance firms is less correlated to the overall economic cycle.

- Interconnectedness between insurance firms is limited and inter-company funding is particularly rare.

- Size is a positive factor for insurers enabling them to better diversify the risk from individual contracts.

- The degree of substitutability in traditional insurance is generally high.

- Insurance firms face much lower liquidity risk – they have more stable, long-term funding sources than banks.

- In the event of an insurance firm failing, an orderly wind-up should already be possible due to its business model: insurers match expected future claims by policyholders with sufficient (mostly long-term funded) assets.

Nevertheless, the IAIS has acknowledged that where an insurance firm undertakes significant NTNI activities, or is highly interconnected with the financial system, it could potentially cause or amplify systemic risk in financial markets. This is particularly the case where insurers engage in investment banking-type activities. This view is reflected in the IAIS' consultation paper on a methodology for assessing an insurer's global systemic importance[19] in which NTNI activities and interconnectivity with the financial system are given the highest weightings (70-85% in total).

In the EU and the UK, regulators are also starting to consider the impact of an insurer's failure on the real economy. Thought is being given as to whether the failure of firms with a market dominant position, particularly in areas such as compulsory insurance, trade credit insurance, and niche insurance, could potentially cause severe market disruption. The key consideration is whether or not other insurance firms would be willing or able to take on the policyholders of the failing insurer within a short timeframe. In the case of compulsory car insurance for example, in a worst case scenario, the result of disorderly failure could be that a significant proportion of the population would not be covered for a period of time, and would therefore be unable to drive.

However, the meaning of 'systemic risk' when applied to the insurance sector is likely to remain a subject of debate well into 2013 and beyond.

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Conclusion

At the policy level, requirements for bank recovery and resolution are advancing. Regulators are turning their attention to the potential risks non-bank financial institutions could pose to the financial system and the broader economy, and the regulatory solutions that should be applied to address those risks. At present, the focus of discussions is largely centred on CCPs and insurance firms.

There is broad agreement that CCPs are systemically important and should therefore not be allowed to fail in a disorderly manner. However, there is much debate regarding how a CCP should be resolved and the potential risks this may cause to its clearing members and broader financial markets. Although the thinking around resolution for CCPs is at an early stage, areas of significant divergence exist between the EU and international suggested approach. A resolution regime for CCPs poses fundamental challenges which largely boil down to the trade-off between keeping 'critical' clearing services running and the level of losses clearing members should be asked to bear in the process. Legal uncertainty remains a significant barrier: will resolution requirements be compatible with national insolvency proceedings?

With regards to insurance firms, the most controversial issue is whether or not insurers pose systemic risk; clarity and agreement is needed on what systemic risk means when applied to insurance activity. At the international level, the focus has been on the impact the disorderly failure of an insurer could have on global financial markets. At the EU and UK level, however, thought is also being given to the 'systemic risk' posed to the real economy by the disorderly failure of an insurer with a large market position in compulsory or trade credit insurance. International, EU and UK approaches are not yet aligned. For the UK a change to the SRR could be required, if for example the EU pursues the harmonisation of existing resolution tools or if any UK insurers are identified as G-SIIs.

IOSCOs anticipated 2013 consultation on additional non-bank sectors, notably hedge funds, will draw increased attention to the applicability of RRPs as a tool to mitigate systemic risk. If 2012 marks a year of progress for banks, the RRP debate for non-banks has just begun.

Appendix A

What are FMI?

The term FMI, as defined by IOSCO in its PFMI, encompasses a diverse range of organisations with very different objectives, functions and legal structures. This includes CCPs, SSSs, payments systems, CSDs and TRs.

All these organisations are considered to be systemically important until a home state national authority declares otherwise and provides a comprehensive rationale for the determination. Nevertheless these institutions create considerably different types and levels of risk to their participants and to the financial system which will need to be reflected when setting requirements for a resolution regime.

Why are FMI important?

FMI firms provide the structures, services, and facilities necessary to support the smooth operation of financial markets. Market participants, and in particular global banks, are considerably dependent on FMI to support their core payments, clearing, trading, and custody activities.

In the aftermath of the financial crisis, the significance of FMI has increased through the G20 commitment that "all standardised OTC derivatives contracts should be traded on exchanges or electronic trading platforms… cleared through central counterparties and reported to trade repositories." At an international level all FMI firms and in particular CCPs are assumed to be systemically important.

FMI are characterised by high interdependence and interconnectivity between financial institutions and with each other. Their disorderly failure or the abrupt termination of critical services could potentially threaten financial stability through severe market disruption and contagion.

FMI that take on credit risk as principal, such as CCPs, pose additional risks. CCPs interpose themselves between counterparties acting as the buyer to every seller and the seller to every buyer, therefore mitigating counterparty credit risk between market participants. Consequently CCPs are a significant source of risk concentration which is compounded by the fact there are so few CCPs and those which do exist tend to focus on a narrow product set. This very low degree of substitutability and the high degree of interconnectedness means the disorderly failure of a large CCP could have severe implications for the financial system.

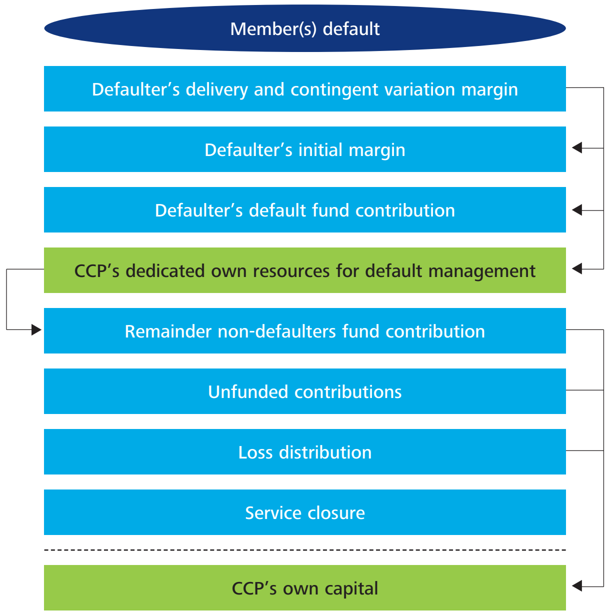
How are FMI firms currently regulated?

FMI are governed by strict restrictions on business activities and, unlike banks, are generally not allowed to take active risk onto their books except where it is required for the provision of core services. For example CCPs assume counterparty credit risk through the clearing services they provide to clients, but are prohibited from extending credit or proprietary trading. All FMI are required to have extensive backup systems and information repositories which can be used in the event of an operational breakdown, such as a systems malfunction.

CCPs in particular are already required to have a number of 'recovery' procedures in place to deal with the default of a clearing member. They collect margin[20] in the form of high quality, liquid assets and contributions from their members and create funds[21] which the CCP can call on in the event of a default of one of its members. CCPs are also required to set up and manage 'default waterfalls' which specify the order in which resources will be used to cushion any losses in the case of a clearing member(s) failing. As part of this process CCPs also plan for a wide range of possible adverse events.

The ‘default waterfall’ process

The below diagram demonstrates how the default of a clearing member is managed:



* The diagram has been produced using Deloitte market analysis. At present default management processes vary across the industry and asset classes.

At the EU level, the European Markets Infrastructure Regulation (EMIR) will further impose a framework for the authorisation and supervision of CCPs and TRs which will include more prescriptive rules on how CCPs manage their default funds and how they are capitalised.[22] This will be complemented by the IOSCO PFMI.

Nevertheless, there is still a risk that in extreme market conditions a CCP may exhaust all its resources, particularly in a situation where the failure of one or several large clearing members is coupled with a decrease in the value of posted collateral. In this scenario the authorities would be left with two options: bail-out the CCP or allow it to close. This would likely result in the immediate unwinding of all outstanding contracts potenially causing market panic and possibly the collapse of several additional clearing members. Public authorities have made it clear that the first scenario is not an option. The current discussion is focused on the possible steps that could be taken to avoid the disruption of the second scenario.

Appendix B

What resolution tools are currently available for insurers?

There are no harmonised EU level requirements for recovery and resolution tools for insurance firms. However several resolution tools exist in different Member States:

- **Run-off** in which firms are required by regulators or voluntarily agree to stop writing new business and existing liabilities mature over time.

- **Portfolio transfer:** insurers (subject to supervisory approval or request) are permitted to sell all or part of their insurance portfolio and related assets to another insurer.

- **Insurance guarantee schemes** are designed to protect policyholders or other beneficiaries from loss due to the failure of an insurance firm by continuing to pay claims if the insurer is no longer able to do so.

- **Bridge institution:** the transfer of insurance liabilities and corresponding assets to another entity on a temporary basis until a buyer(s) can be found.

- **Restructuring of liabilities** can be carried out through court proceedings or under authorisation from a supervisor and involves distributing some losses amongst policyholders or creditors.

- **Compulsory winding-up** is used as a last resort and involves immediately closing down the insurance firm. The present value of contracts to policyholders and creditors is paid out in a specific order until funds run out.

In addition several Member States have **existing early intervention powers** including the ability of supervisors to request that insurers submit recovery plans. Some authorities also have the power to prohibit free disposal of assets and impose restriction on new business or ban certain operations.

Notes

1 EC, *"Consultation on a possible recovery and resolution framework for financial institutions other than bank"* (Oct 2012).

2 As set out in the CPSS-IOSCO *"Principles for financial market infrastructure"* (April 2012).

3 The Clearing House Payments Company, L.L.C. CLS Bank International, Chicago Mercantile Exchange Inc, The Depository Trust Company, Fixed Income Clearing Corporation, ICE Clear Credit LLC, National Securities Clearing Corporation, The Options Clearing Corporation.

4 Payment systems and payment institutions are also mentioned in the paper but the EC largely excludes their suitability for a resolution regime. Payment systems are deemed to be subject to close oversight from the European System of Central Banks and the European Central Bank. Payment institutions are not considered to be systemically important due to their small share of the overall payments market and the fact that they do not take deposits or enjoy guaranteed access to payment systems.

5 Such a methodology already exists for identifying G-SIBs and is currently under development for G-SIIs.

6 It is acknowledged that the sale of business tool could be difficult to implement in practice due to the small number of FMI in operation and the asset separation tool is deemed largely unsuitable for an FMI's business model.

8 The termination of any unmatched contracts held by the non-defaulting clearing member.

7 See appendix A for an overview of current loss-sharing requirements for CCPs and their clearing members.

9 HMT, *"Financial sector resolution: broadening the regime"* (Aug 2012).

10 HMT, *"Financial sector resolution: summary of responses"* (Oct 2012).

11 CPSS-IOSCO, *"Recovery and resolution of financial market infrastructures"* (July 2012).

12 See appendix B for a more detailed overview of what each of these requirements would entail.

13 The bail-in tool would only not apply to secured debt, collateral, insurance policies, client assets or liabilities such as salaries and taxes.

14 See the Bank of England and FSA's paper: *"The Bank of England, Prudential Regulation Authority: The PRA's approach to insurance supervision"* (Oct 2012).

15 The PIF is designed to ensure that the PRA can identify and respond quickly to risks to an insurer's viability. There are five stages in the PIF. Stage one is categorised as low risk to the viability of an insurer, conversely stage five refers to the resolution of an insurer. Supervisory intensity and regulatory requirements increase progressively at each stage.

16 IAIS, *"Global Systematically Important Insurers: Proposed Policy Measures"* (Oct 2012).

17 The Financial Stability Board's *"Key Attributes of Effective Resolution Regimes for Financial Institutions"* (Nov 2011).

18 There are several papers which express this viewpoint including the IAIS paper on "*Global Systemically important Insurers: Proposed Assessment Methodology*", May 2012.

19 IAIS, *"Global Systemically Important Insurers: Proposed Assessment Methodology"* (May 2012).

20 Margin is the difference between the actual price of a trade at execution and the expected price if the CCP had to replace the trade in the event of a clearing member defaulting. It is calculated using a risk based approach, for example the volatility of the underlying instrument on which the contract is based and the length of time until close-out are taken into consideration. All clearing members post initial margin, their positions are then marked-to-market on a daily basis and variation margin is either paid to or received from the CCP based on losses/gains made on the trade during the day.

21 Clearing members must provide default fund contributions and margin in the form of highly liquid assets such as a cash denominated in a major currency, gold, certain financial instruments (e.g. T-Bills) and central bank guarantees (all subject to strict criteria).

22 This will need to include a wind down plan which will demonstrate to the authorities that the CCP has sufficient capital resources outside of the default waterfall to withstand any operational expenses that could be incurred over a 6 month wind-down period.

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