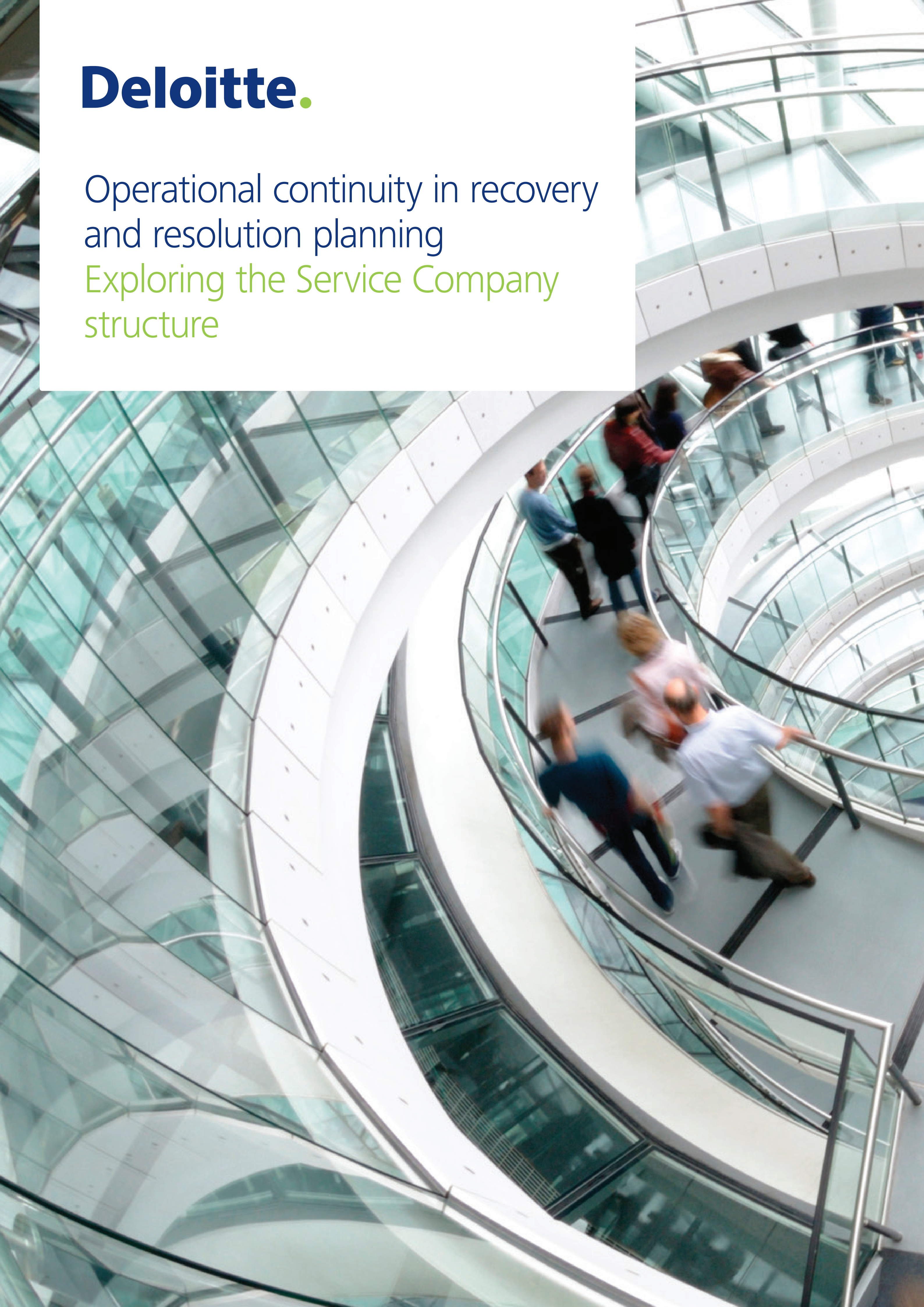
Operational continuity in recovery and resolution planning

Exploring the Service Company structure



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The requirement for operational continuity in recovery and resolution planning

Operational continuity – keeping the lights on, and the provision of critical shared services[1] required to support core banking activities – is at the heart of "business as usual", but it takes on a particular importance in the context of recovery, resolution and post-resolution planning.

Regulators, resolution authorities and standard-setters such as the Financial Stability Board (FSB) are asking banks to demonstrate that vital infrastructure and operations (which in this context turn out to be extensive, complex and often cross-border) will continue to be provided throughout any stabilisation and restructuring process in the event of severe financial stress.

The six sections in this paper cover:

- the definition of operational continuity;
- how regulators are addressing operational continuity;
- the exploration of the Service Company structure;
- the challenges to the Service Company structure;
- areas to consider before implementation; and
- how Deloitte can support you.

1 "Critical Shared Services" are services which support one or more of a group's material entities or business units in performing critical economic functions and where the sudden or disorderly failure of the shared services would lead to a serious disruption in the performance of these material business units or entities" (PRA DP1/14, 'Ensuring operational continuity in resolution'); in its recent consultation paper, the European Banking Authority (EBA) specified a list of services "to be construed as a minimum" including human resources and information technology. For a full list please see EBA CP/2014/23 "Draft Guidelines on the minimum list of services or facilities that are necessary to enable a recipient to operate a business transferred to it under Article 65(5) of Directive 2014/59/EU), available at: http://www.eba.europa.eu/documents/10180/825276/EBA-CP-2014-23+%28CP+on+GL+on+Minimum+List+of+Services+and+Facilities%29.pdf

Operational continuity: what is it and why does it matter?

The continuity of critical shared services is a crucial[2] part of the process of identifying and removing impediments to recovery, resolution and post-resolution restructuring.

2 Other elements that are also key for resolution to be effective, such as funding, group legal entity structure and valuation, are not discussed in this short paper.

The nature of existing service provision models means that there are often numerous such impediments, each of which could cause significant disruption to the continuity of services in executing recovery, resolution and post-resolution restructuring actions. For the past five years, Deloitte has been working with financial institutions to address some common issues, including:

Complex technology: the interconnected nature of legacy infrastructure, systems and data may mean that access to information and services during recovery, resolution or post-resolution restructuring could be constrained. This could result in a number of issues: regulators' concerns about access to systems and data to provide rapid valuations and re-valuations during resolution; provision of a single view of the customer; and logical separation of data between trading entities / jurisdictions in the event of post-resolution restructuring.

The ability to retain key employees: an event of severe financial stress may impair a bank's ability to pay and retain employees, including those deemed essential to ensure operational continuity. Furthermore, employees may provide services to more than one part of the bank and it may not be possible to separate out these shared services quickly.

Premises lease termination provisions: banks may lease a large number of premises, including offices, physical branches/ATMs and data centres. In any event of non-payment, including lack of working capital due to recovery, resolution or post-resolution restructuring causes or consequences, landlords may have the legal right to withdraw access to properties or terminate leases which may be relied upon by key operations and services. In addition, premises are often used by more than one division of a bank, which would be difficult to quickly separate/segregate in the event of the division of a group across different new owners.

Third-party contract termination provisions: third-party supplier contracts for goods and services which are relied upon for critical operations may contain termination clauses (e.g. upon non-payment or insolvency) and restrictive change of control provisions, which could put the provision of these goods and services at risk. Such contracts may also be shared across different trading entities in a bank. In the event of severe financial stress, untangling these intra-group arrangements in order to transfer them to a new party, or parties, would put at risk the contract validity and/or supply if the standard agreements are not amended to allow for recovery, resolution and post-resolution restructuring well in advance.

Complex operations, often in multiple international locations: it can be hard to map a bank's structure after years of organic and merger growth. To think about how to approach and identify interdependencies, firms need to consider transitional service agreements and systems access, and how to guarantee their ongoing availability to different parts of the business without splitting them off in their entirety or running two (or more) versions of 'everything'.

Contractual relationships (within the group and with third parties): the nature of such relationships requires consideration. Are both parties at legal arm's length (where governance is at least as important to consider along with compliant transfer pricing)? Is the contractual relationship legally enforceable in a resolution scenario? How are they structured and what would the consequences of resolution be? A particular issue can arise if critical shared services are supported from different countries – whether the nature and reach of the service contracts in these cases can be relied on to continue irrespective of resolution.

In order to address these impediments and aid overall resolvability, banks will be required to make changes to their operational structures and intra-group service provision models. Solutions will be specific to each bank depending upon its business strategy, chosen organisational structure and timing of any change (e.g. whether to be a leader or follower; whether to wait for a regulatory requirement or move voluntarily), while considering possible implications for the broader cost base and operational efficiencies.

Operational continuity is interlinked with a broader set of measures regulators are considering implementing around banking reform and stabilisation strategies, including the UK Banking Reform Act and FINMA is 'too big to fail' regime.

An event of severe financial stress may impair a bank's ability to pay and retain employees, including those deemed essential to ensure operational continuity.

Emerging considerations from the UK's Prudential Regulation Authority (PRA)

In setting out its preliminary views on the key issues and questions surrounding operational continuity, the PRA recently published a Discussion Paper (DP 1/14) on the topic and initiated a three month consultation.[3] The outputs will allow the PRA to continue developing rules and guidance on the subject of operational continuity in resolution.

While clearly UK-centric, it is likely that guidance elsewhere in Europe (given the EU Recovery and Resolution Directive), the Americas and Asia (given the shared FSB Key Attributes) may evolve along a similar path.

The PRA paper sets out three design principles for operational continuity:

- **Design Principle 1** – *Restructuring Capabilities* – the provision of critical shared services should be structured in such a way that ensures the service entity is able to facilitate recovery, resolution and post-resolution restructuring plans.
- **Design Principle 2** – *Contractual Service Provisions* – delivery of operational services should be undertaken via transparent contractual agreements, capable of facilitating transferability of services and service relationships, if required.
- **Design Principle 3** – *Financial and Operational Resilience* – a provider of critical shared services should have a sufficient level of available capital and liquidity in order to ensure that it can continue to operate and restructure its operational capacity, irrespective of the severe stress, failure or resolution of any serviced entity.

Further, the PRA has provided the first set of assessment criteria that we have seen on which a bank's operational continuity could be judged:

1. **Ownership Structure** – Critical shared services must be structured in such a way that, upon resolution, no entity in the group experiences disruption in critical services.
2. **Objective Service Agreements** – Critical shared services should be clearly and precisely identified using 'granular' service level agreements (SLAs). One of the consultation questions is whether banks should be required to have central repositories for SLAs.

3 PRA DP1/14, 'Ensuring operational continuity in resolution', available at http://www.bankofengland.co.uk/pra/Pages/publications/cp/2014/dp114.aspx

3. **Charging Structure** – Charges should be made on an arm's length basis, ensuring that any shared service provider is not reliant on capital injections from other parts of the group. This should be the same whether the shared service provider is a separate entity, or within the regulated entity.

4. **Scale and Scope** – Critical shared service providers should not be unnecessarily large or complex and should only provide transactional services which can be represented in contractual terms. This excludes services requiring strategic judgement (e.g. risk management), or that may result in financial exposures.

5. **Governance Structure** – The critical shared service provider should have its own governance structure. The management team should be sufficiently independent enough to operate without a parent entity if it went into resolution.

6. **Ownership or Continued Access to Operational Assets** – Access to operational assets by the critical shared services provider should not be disrupted by a resolution event. In some cases, this may require that the operational assets are the same legal entity that performs these critical shared services to minimise conflicts of interest and litigation disputes around these assets.

7. **Operational Resilience** – In the event of a group entity failing, the critical shared service provider should have sufficient staff and other assets to ensure self-sufficiency, utilising credible operational contingency arrangements.

8. **Financial Resilience** – A critical shared service provider should have sufficient financial resources (capital and liquidity) to maintain service provision irrespective of the severe stress, failure or resolution.

The majority of the draft criteria published for discussion by the PRA was largely expected by the industry however, given the size of operational capacity banks rely upon, the impact of the proposed financial resilience principle are at the top of everyone's agenda, as it is likely to create incremental costs.

The criteria are expected to further develop before final rules and guidance are published in the UK, with similar discussion likely in Europe, the Americas and Asia. In addition, the FSB intends to develop guidelines to support operational continuity in resolution by the end of 2015.

In its latest publication the PRA also recognised several potential structures for effectively dealing with operational continuity:

- a dedicated intragroup Service Company providing critical shared services to one or more regulated entities;

- an operational division providing critical shared services from within a regulated entity with attributes that would allow the resolution authorities to implement a separate Service Company model should they need to;

- outsourcing critical shared services to third-party providers; and/or

- a combination of the above.

Although there are a number of viable options available, the Service Company option is one solution that a number of large banks have been exploring for several years as a means to achieving operational continuity as well as providing group-wide, cross border, shared services.

The next section of this paper discusses this option in more detail, looking at the 'how'.

A viable solution? Exploring the Service Company structure

All the above solutions appear to have strengths and weaknesses associated with them, though only the Service Company approach (also referred to as 'operational subsidiarisation') allows banks to meet operational continuity requirements whilst maintaining and building shared services capability.

Compared with other possible alternatives, it avoids the significant task of untangling and duplicating complex service delivery models. Based on our estimates, these costs can sometimes be as much as 5 times more expensive to build and run than the Service Company would be.

A Service Company solution, correctly implemented, should ensure that key services and infrastructure relied upon by critical functions are held by a subsidiary that is structured to enable operational continuity through business as usual, resolution, recovery and post-resolution restructuring. We consider the practical considerations when assessing and implementing the Service Company option in a later section; in the table opposite, we assess the Service Company option against the PRA's assessment criteria:

PRA's Assessment Criteria	Service Company as a solution
1. Ownership Structure	**Moderate** – Operational services, infrastructure and facilities are held in a separate legal entity. There are several options for ownership structures that the PRA has recognised and depending on decisions made by banks this solution could deliver a moderate alignment of this criterion.
2. Objective Service Agreements	**Strong** – The establishment of commercial intragroup service agreements between the service entity(-ies) and its service recipients along with their arm's length nature ensures the contractual arrangements remain valid and enforceable following a bank failure.
3. Charging Structure	**Strong** – Charges for services are set on a truly arm's length basis, thus ensuring the Service Company is not reliant on discretionary capital injections by other entities in the group.
4. Scale and Scope	**Strong** – An operational Service Company will only provide transactional processing and will not take on financial exposures and / or related activity which can result in such exposures.
5. Governance Structure	**Moderate** – As a separate legal entity, a Service Company will be governed through its own governance and management structures, thus ensuring it remains agnostic to the type of failure and the extent of the impact on trading entities and product/service lines. However the entity will remain part of the overall group and will be subject to its governance.
6. Ownership or Continued Access to Operational Assets	**Strong** – The separate legal entity structure ensures that all operational assets are legally separate from the financial assets and liabilities.
7. Operational Resilience	**Strong** – The transfer of infrastructure and staff (technology, premises and contracts) to a separate legal entity ensures sufficiency. Particularly if it has its own crisis management arrangements in place.
8. Financial Resilience	**Strong** – Having sufficient financial resources held in the name of a Service Company operating outside of a PRA regulated entity (and potentially with a third party), could provide adequate assurances for the uninterrupted access to liquid assets and loss absorbing resources by a service provider, regardless of the failure or resolution of other group entities.

Based on our estimates, these costs can be sometimes as much as 5 times more expensive to build and run than the Service Company would be.

Practical considerations of a Service Company solution. Is it right for you?

Through implementation of a Service Company approach, banks could overcome many (possibly all) of the infrastructure impediments to recovery, resolution and post-resolution restructuring, and still continue to provide critical functions uninterrupted, irrespective of the health of all or part of the bank at a cost.

There are a number of practical considerations for whether this approach is the right one, both in the solution itself and its implementation. We summarise the key considerations as follows:

Third-party and internal agreements – held by the service entity would need to be legally robust and designed to ensure the uninterrupted provision of services while resolution actions are being taken. These agreements will require detailed service mapping to identify the scope of services being provided by the Service Company, potentially a mammoth task given the scale of a large bank's operational and technology footprint. The agreements may also need to be drafted or reviewed by external legal counsel to ensure they are sufficiently resilient throughout the resolution process and any subsequent litigation disputes.

Funding arrangements – providers of critical shared services are largely expected to operate on commercial principles for the purposes of service provision in normal operations. However, given their limited customer diversification, the entry of one or more group trading entities into resolution may cause a temporary loss of revenue and significantly impact the ability of the service provider to restructure, trade solvently and maintain critical shared services. Such business risks can be mitigated through the provision and availability of adequate capital and liquidity resources. A key question in this context is the size of capital and liquidity resources alongside location (i.e. not putting the money for a 'rainy day' into the trading entities taking on market risks), types of liquid assets and how capital resources are provided to the service entity while ensuring effective utilisation of resources for the purposes of revenue generation.

Pensions – Service Company will need to be independent of joint and several liabilities with the rest of the group,[4] which may be achieved for example by setting up a new 'clean' legal entity. This may manifest itself in a number of ways (VAT is another example), but perhaps one of the most significant is as a result of pension liabilities – when many employers share a group-wide pension defined benefit scheme, if one fails the several liabilities of the entire scheme would lie with the other employers. A Service Company will need to be independent of joint and several liabilities with the rest of the group. This may manifest itself in a number of ways (VAT is another example), but perhaps one of the most significant is as a result of pension liabilities – when many employers share a group-wide pension defined benefit scheme, if one fails the several liabilities of the entire scheme would lie with the other employers. This independence may be achieved for example by setting up a new 'clean' legal entity.

Governance of the entity – will also require thought and a number of questions will need to be addressed, particularly in the absence of clear guidance on service entity governance from international regulators. Should Directors be able to hold roles in the Service Company and also the trading entities? If so, what proportion of the Board of which company? If so, both will be their employer – is there a conflict of interest in the event of financial stress? Also are Non-Executive Directors required to provide independent oversight?

Jurisdictional requirements – given the global nature of many banks' IT and operations, any solution will need to address cross-border continuity, meeting the requirements of relevant host authorities. This will involve appropriate engagement with these authorities, from communication of the planned change, to seeking approvals where required. It may also need extensive legal and tax analysis to understand the impacts of any proposed changes given the complexities in various jurisdictions – a task which should not be underestimated.

Tax and transfer pricing – placing critical operations in subsidiaries carries with it significant tax and transfer pricing implications. There is a growing focus on tax transparency in the global business community, meaning that any Service Company would need to have clear tax and transfer pricing arrangements in place, utilising the internal and external legal agreements mentioned previously. For banks with complex, global operations (including a significant multi-country presence) this may prove very challenging.

Given the emerging nature of the regulatory requirements and the complex and complicated operational infrastructures held by banks, to make a Service Company project successful, as next steps, the following should be carefully considered and ensured:

- A clearly defined and agreed problem statement on which to base the Service Company scope and design.
- A robust feasibility assessment for the suitability of the Service Company option.
- Strong senior stakeholder buy-in to the project and Service Company design.
- Sufficient senior design authority to make decisions and provide assurance throughout implementation.
- Alignment with the bank's overall strategy and change agenda.
- Alignment with the bank's response to any retail ring fencing requirements.
- Regulatory endorsement of the bank's particular Service Company scope and design.

4 UK banks face similar requirements as a result of the Banking Reform Act's ring-fencing requirements.

Will all banks be required and/or choose to have such Service Companies?

Whilst a fully implemented Service Company solution could go a long way in addressing issues in relation to operational continuity, it should not be considered in isolation but rather as an integral part of a wider set of measures aimed at enhancing resolvability.

For example, a Service Company solution could ensure the operational continuity of payments processing. However, additional payments impediments such as continued access to financial markets infrastructure as well as provision of sufficient intraday liquidity will need to be addressed through separate measures and tools.

Therefore, if a Service Company structure is pursued, it should be carefully analysed and compared with a range of alternatives, with costs modelled against perceived benefits and within the context of overall resolution strategy.

The need to get it right

Operational continuity is part of a wider movement by regulators to ensure global systemically important financial institutions are prevented from being "too-big-too-fail". There are several other pieces of regulation that regulators are using in conjunction with operational continuity, including Structural Reform.

To say the banking industry is undergoing 'change' is an understatement; it is going through 'transformation'. The initial financial outlays for this transformation will be significant and banks are realising the importance of ensuring that they get it right, preferably the first time.

Deloitte has been working with several major cross-border institutions to develop their responses to regulatory authorities and to develop their future plans. We have multiple employees who are working together to understand the implications of proposals and solutions not only for individual firms, but the industry as a whole.

Despite the costs and complexity of transitioning to the Service Company approach, it has more appeal than duplication and segregation of operations and IT systems, with the loss of synergies (actual and potential) that this implies. Given announcements made to date, Deloitte expects to see some internationally active banks (which are subject to different types of ring fencing) start to transition to this model beginning in 2015.

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