First take

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Ten key points from regulators' feedback to Wave 1 resolution plan filers

Raising the bar: A path towards credibility

On August 5, 2014, Wave 1 filers[1] received feedback on their second resolution plans, ten months after their submissions in October 2013 (and one month after filing their 2014 plans). Each of the eleven firms received letters, signed jointly by the Federal Reserve ("Fed") and the FDIC. The timing of the long-awaited feedback was largely unanticipated, although it was similar to the nine and a half months taken by regulators to provide general guidance to the initial plans submitted on July 1, 2012 (when the Too-Big-To-Fail ("TBTF") debate was also making headlines).

The letters were substantive (typically 15 to 20 pages in length) and generally reflected a thorough review and analysis of the firms' plans. They included feedback that was common to all Wave 1 filers, as well as guidance customized for each firm. While the regulators acknowledged some important improvements in the firms' 2013 submissions versus their 2012 submissions (e.g., a more readable narrative, and progress in addressing the five key categories of obstacles to resolution),[2] the regulators also identified significant shortcomings and actions needed to improve resolvability for the July 2015 submissions.

The strongly worded joint press release by the Fed and the FDIC, as well as statements issued by the Fed and individual FDIC Board members, leave no doubt that there is substantial work to be done over the next year if the firms are to avoid the potential significant consequences of a formal "not credible" determination.

1. **Path to credibility:** Despite what some press headlines imply, the letters did not constitute a finding of "not credible" per the Dodd-Frank Act's 165(d) rule (which requires a joint determination of non-credibility by the Fed and FDIC). The regulators publicly expressed their different stances on the status of the plans. The FDIC drew a line in the sand and deemed all 11 plans "not credible," while the Fed, which has long viewed the plans as an "iterative process," determined that all 11 firms had to take immediate action to improve their resolvability. The FDIC's public stance has put the Fed in somewhat of a bind though. With resolution planning so important to the TBTF political debate, expect the Fed to demand much more out of the plans going forward in order to avoid again being the only regulator with no opinion as to the plans' credibility.

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[1] Wave 1 filers are generally firms with $250 billion or more in US nonbank assets.

[2] See PwC's Regulatory Brief, *Resolution Planning: New guidance, more time, no specificity* (April 2013).

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2. **Substantive operational and structural changes:** Unlike the guidance received in April 2013, which was largely focused on improving the plans' quality (e.g., structure and readability) and scope (e.g., five categories of obstacles, additional questions, and more detailed analysis), the feedback strongly criticized the firms for failing to consider the inadequacy of their existing operating models to withstand the risks associated with failure and directly instructed firms to make substantive operational and structural changes. These changes will not only require extensive and challenging legal and business analysis, but they also raise the stakes regarding choosing the right operating model that best positions the firm to manage stress both as a going concern (i.e., recovery) and in resolution. Critically, what is good for business-as-usual may not align with what is best for resolvability, particularly with respect to operational and funding interconnections. Some other changes, such as amending financial and vendor contracts, will affect not only the firms themselves but their counterparties and trading partners as well.

3. **Fundamental changes to financial contracts:** A stay of early termination rights that is currently accorded to counterparties in most derivative and other financial contracts must be explicitly incorporated into such contracts. The feedback was clear that firms must work with ISDA and other industry groups to effect fundamental change industry-wide, while taking action now to similarly amend bilateral contracts not yet captured by those industry-wide efforts.

4. **Rationalizing complex group structures:** The regulators believe that the legal entity structures of the largest firms are unnecessarily complex and that alignment between legal entities and businesses should be closer. Firms are required to "establish a rational and less complex legal structure" to address these concerns. Firms will need to develop frameworks for evaluating and optimizing their legal structures where resolvability and business concerns (e.g., operational efficiency, profitability, risk management, and even resilience/recovery) may not align. Resolvability considerations will likely need to take priority if firms are to convince the regulators that they have truly made progress on this issue.

5. **Increased focus on the holding company:** The holding company should be structured to "support resolvability." Consistent with longstanding "source of strength" guidance, the regulators are encouraging firms to position the holding company to minimize encumbrances with its operating entities and to demonstrate capacity to provide financial support. This focus on the holding company may be in anticipation of bail-in debt requirements to recapitalize operating subsidiaries in resolution.[3] The holding company would be the issuer of long-term debt and equity for use throughout the firm, subordinating the holding company's obligations to those of the operating subsidiaries.

6. **More substantiated and "worst case" assumptions:** The regulators believe that the plans are based on assumptions that are "unrealistic or inadequately supported," especially when considering adverse economic conditions or the actions of customers, counterparties, financial market utilities, and foreign regulators. As we have previously suggested,[4] the burden is on the firm to prove the reasonableness of assumptions. It is not surprising that the regulators have begun to focus on what would happen if certain assumptions turned out to be incorrect or begun to require failure scenarios with more severe capital losses or liquidity failures (and greater modeling rigor).

7. **Ensuring continuity of critical operations:** Since many of the largest firms provide services that are considered critical to the financial stability of the US, firms must demonstrate convincingly that all the resources required to continue those services will be available in resolution (at least until they can be transferred to other operators, if necessary). This may require changes in the specific legal entities that employ or own vital resources (e.g., essential personnel, or IT systems and data) and ensuring that funds are available in the right entities at the right time to ensure their sustainability during resolution. Moreover, operationalizing the resolution plan to ensure continuity of operations will require firms to treat resolution planning as more than just an internal exercise, as we have also suggested previously.[5] Engagement will be required with outside parties such as vendors, financial market utilities, and key correspondent relationships.

8. **Raising the bar on demonstrating operational feasibility:** Firms must "demonstrate operational capabilities for resolution preparedness." The Fed has provided guidance on this issue across several dimensions, most recently

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[3] See PwC's Regulatory Brief, *Resolution planning: Bail-in debt rule slowly taking form* (October 2013).

[4] See PwC's Regulatory Brief, *2014 Resolution Plans: The guidance you won't receive* (April 2014).

[5] See prior note.

in SR 14-1, including mandating identification of needed data and reporting capabilities (focusing on immediately accessible MIS, collateral management systems, and continuity of shared services). For their 2015 plans, firms should evidence sustained capability to produce the critical information needed to execute preferred resolution strategies (beyond just describing the information) and must be able to mobilize key personnel. Firms should be prepared to formally test these capabilities for regulators. For some firms, significant systems improvements and process re-engineering will be required.

9. **More publicly disclosed information:** The feedback signals that the regulators are working on additional requirements to provide greater public transparency into resolution plans. While the regulators acknowledge the balance between transparency and confidentiality of proprietary and supervisory information, firms should expect that they will be asked to provide more than the modest high-level summaries shared in the current public portions.

10. **A tall order:** This new set of feedback will undoubtedly result in significant work for the impacted firms. Now, in addition to the extensive effort already required to refresh plans to be compliant with the 165(d) rule and general guidance provided in 2013, firms will also need to devote time and resources to (a) rethink their operating models, (b) begin to implement proposed changes (or, at the very least, present a concrete plan for implementation), (c) demonstrate that proposed changes effectively mitigate identified obstacles and improve resolvability, and (d) revise previously submitted information to reflect any material changes and ensure a sufficient level of detail is provided. It is a daunting task that will require even greater involvement from the Board and all levels of management to meet the regulators' credibility standard, while still meeting ongoing business requirements and achieving required returns.

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