Regulatory brief

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2017 Public sections: The resolution evolution

The recently released public sections of the 2017 resolution plans submitted by the eight US global systemically important banks (G-SIBs)[1] provide a unique window into the banks' resolution planning efforts that have developed over the last five years. Notably, the 2017 plans not only describe how the banks have enhanced their resolution plans but also highlight improvement in their intrinsic resolvability, which is indicative of the mindset change that has evolved over the past seven years: resolution planning has developed from a one-time compliance "project" to an important strategic consideration for business-as-usual (BAU) financial and operational choices.

These fifth[2] edition plans reflect the first full plans since the Federal Reserve (Fed) and Federal Deposit Insurance Corporation (FDIC) (collectively, the Agencies) determined in April 2016[3] that all of the G-SIBs' 2015 plans had either deficiencies preventing the plan from being considered credible,[4] or less-serious shortcomings, or both. In the 2017 plans, the G-SIBs were expected to remediate the less serious shortcomings as well as meet the heightened expectations presented by the Agencies in new guidance released last year (2017 guidance).[5]

The plans generally acknowledge and explicitly address each of the weaknesses found in prior plans, and reflect the priorities and requirements set by the Agencies in the 2017 guidance. With a strong advocacy sub-text, the public sections all state that the plans have been enhanced, the shortcomings addressed (generally accompanied by an itemization of the actions taken to do so) and, most importantly, that the banks themselves are now resolvable with controls in place to maintain such resolvability over time. Achieving the current state has taken time – and has been expensive; one bank even indicated that it has spent $2 billion and annually invests more than 1 million hours to have reached this point.

However, the Agencies have traditionally been skeptical of such confidence from the banks. Looking ahead to the review of the 2017 plans, we expect the Agencies to want proof that all is as described, potentially through a horizontal testing phase. Further, even if the plans all pass muster, the Agencies may strive to level up all banks' capabilities in line with the best of the peer group or encourage best practices in their feedback. As such, we do not expect any lowering of the credibility bar for the largest banks, which have received criticism from both sides of the aisle.

It is possible, however, that requirements may stabilize or, at the very least, rise less quickly as leadership changes at the Agencies.[6] Further, there are clear signs that the Agencies may ease pressure in terms of submission frequency or the volume of information firms are required to submit. Nevertheless, it is clear from the significant progress and investment made over the years that resolution planning is and will remain a key part of the broader supervisory framework.

This **Regulatory brief** analyzes common themes in the largest US banks' 2017 resolution plan public sections and provides our view on what's next.

Themes of the 2017 resolution plans

No summary of the 2017 public sections would be complete without a comment on the clear trend toward a more user-friendly style and format. Despite the increased length (more than 100 pages on average, compared to 29 in 2012) and discussion of many complex topics, most of the plans seem easier to read than has been the case in the past. The use of plain English, combined with straight-forward explanations and contextualization, makes the plans easily digestible. For example, a number of the G-SIBs incorporated the use of a "frequently asked questions" format, clear but simple graphics (e.g., timelines, matrices, organizational charts) and glossaries to help tell their story.

While banks seem to have made individual choices on the particular aspects of the plan to prioritize or emphasize, the public sections overall seem more alike than different. Not surprisingly, enhanced governance tops the priority list among the common themes, while more robust financial forecasting also features quite prominently. Most of the plans describe considerable legal analysis and related work completed to support the resolution strategy, as all but one of the banks have adopted a Single Point of Entry (SPOE) strategy.[7] Further, to support plan feasibility and optionality, many of the banks prepared numerous playbooks detailing possible divestitures or other activities that would need to be executed quickly during stress.

Importantly, the plans evidence completion of actual changes to improve resolvability. For example, some have included changes to the structure of the organizational arrangement of legal entity affiliates and a reduction in the number of legal entities (often significantly), modifications to how the banks fund and provide services to affiliates and, in some cases, the exit or sale of certain activities.

Governance

The evolution of resolution planning is nowhere more evident than it is in the area of governance, particularly in terms of having monitoring processes in place to know when the resolution strategy must be executed. The earliest public sections merely mentioned the individual or body responsible for the preparation of the resolution plan whereas in the 2017 plans governance is a high priority with a considerable level of effort and discussion. Detailed "Governance Playbooks" became a requirement for all the G-SIBs' 2017 plans after the Agencies identified several shortcomings and some deficiencies with respect to triggers in some of the 2015 plans. Several banks had already prepared Governance Playbooks for previous plans, which indicates that this is an example of the Agencies leveling up a "better practice" to a requirement.

In the 2017 plans, all of the G-SIBs described the enhancements made to their governance frameworks, including the development of objective resolution triggers and associated tactical actions that are required of management and Boards as the bank's financial condition changes from BAU through various levels of stress, recovery efforts, and resolution. In addition, many banks broadened or strengthened the governing bodies responsible for monitoring triggers and executing associated actions accordingly.

Financial condition, modeling and metrics

Taking cues from the old adage "an ounce of prevention is worth a pound of cure", the G-SIBs have highlighted their advancement from 2012 to 2017 in terms of improved financial condition and lower risk profiles. Back in 2012, the financial component of the public sections was limited to a few, high level metrics on some of the material entities – generally nothing beyond what could be found in the annual report. From a financial disclosure perspective, the 2017 plans include high level financial information on each material entity, together with a description of the main business activities of each. The plans also acknowledge that capital and liquidity resources have been pre-positioned in key material entities and levels are being monitored on an ongoing basis.

More importantly, however, the 2017 plans go into much more depth on the banks' financial models in response to the 2017 guidance, which made clear that the Agencies expected the banks to have rigorous financial modelling capabilities, particularly for capital and liquidity needed to execute the resolution strategy.[8] Among the notable enhancements in the 2017 plans are capabilities such as the production of daily cash flow and financial statements under varying conditions at the material entity level.

SPOE reigns

In 2015, we highlighted the notable shift toward an SPOE strategy among the US G-SIBs.[9] That shift continued this year as seven of the eight US G-SIBs now have an SPOE strategy[10] while only Wells Fargo currently maintains a Bridge Bank strategy.[11]

Although the SPOE strategy should be less disruptive to the financial system and allow for a more orderly resolution, it has never been executed in a bank failure scenario, and there are numerous legal and operational complexities. To improve credibility, the 2017 plans detail SPOE strategy mechanisms, including structural changes and the significant investment in legal preparation made to facilitate the execution of the strategy. Structurally, most banks have created or repurposed existing legal entities to serve as intermediate holding companies (IHCs) and generally have pre-positioned financial resources at the IHC. To facilitate the shift of resources between the existing parent company and the operating subsidiaries while also guarding against potential future claims of fraudulent conveyance, the banks have entered into similar legal agreements between and among affiliate entities.[12] Importantly, these agreements are described as already executed and effective.

In addition, a number of the banks indicate having drafted the appropriate legal documents to facilitate the parent's bankruptcy filing. Unlike the support agreements, these documents have been prepared in draft format to be ready in the event that they are needed, but they are also no longer treated as a theoretical exercise. Further, even with a SPOE strategy, the banks recognize the likely need for options that could help reduce the size of the remaining company and potentially raise capital or funding once the parent has entered bankruptcy. As such, the banks indicate in the 2017 plans that numerous playbooks have been created to facilitate the separation and sale, spin-off, or wind-down of businesses or portfolios.

Actual changes to business and structure to improve resolvability

In 2012, the banks were required to identify potential obstacles or impediments to an orderly resolution and develop plans to eliminate or mitigate those risks. The 2017 plans show evidence of structural changes made to execute those plans over the last several years, including reductions in the number of legal entities within some organizations. Although some of the reductions are quite significant, many have been completed for years and many of the closed entities had already been dormant. Further, the reality is that several organizations still have thousands of legal entities and the number of legal entities is not the sole (and not even the most significant) determinant of complexity.

In earlier feedback, the Agencies called upon the banks to justify their seemingly complex legal entity organizations through the creation and application of Legal Entity Rationalization (LER) criteria. The Agencies, however, were generally unimpressed with the level of achievement as of 2015. Consequently, the banks fine-tuned their LER criteria and stepped up their efforts to implement them, which includes assessing existing structures against the criteria and identifying opportunities for change where existing structures or practices diverge from the criteria. In doing so, many of the banks made structural changes to 1) more cleanly align business activities or supporting resources with legal entities, 2) reduce the ownership or funding complexities between affiliates, or 3) better centralize booking models and align risk management of certain activities.

Another major area that led to deficiencies in the 2015 plans is the availability of resources and services in resolution, particularly those "shared services" that are performed by one legal entity (or set of legal entities) and consumed by another legal entity. A number of firms enhanced their disclosure on their "service delivery models" by providing matrices to show how services (and funding) are provided and received within the organization. Some firms indicate significant restructuring to centralize provision of shared services in either the main bank or dedicated material service entities. Not surprisingly, some firms named a number of new material service entities.

A related element to these efforts is the completion or enhancement of documentation through service level agreements (SLAs) to acknowledge the exchange of services between affiliates. Most firms also indicate that they have developed technology to track the exchange of services (and associated documentation or contracts) and established specific governance to oversee the service delivery model. These improvements provide a planning roadmap so that plans can be made and funds can be budgeted to sustain receipt of the services required for an orderly resolution, even if the service provider and receivers are separated (e.g., through sale or failure) in a resolution scenario.

Derivative wind downs

In the earliest plans, discussion of derivatives in the public section was limited to the documentation required for regulatory reporting, with no real strategy for dealing with derivatives in resolution. In the 2017 plans, the G-SIBs have taken multiple steps to deal with the real issues associated with derivatives (and other qualified financial contracts) in resolution. In addition to adopting the new International Swaps and Derivatives Association (ISDA) protocol as required,[13] the banks with material derivative positions did deeper analysis of the financial and operational implications of both active and passive wind down strategies, which were then incorporated into the 2017 plan. Several of the banks have also reduced the number of inter-affiliate derivatives transactions to reduce the risk such transactions pose to the firm. Early termination of derivatives has historically been a meaningful concern because of the potential for widespread transmission of risk and asset fire-sales from the failure of one major bank. The enhancements highlighted in the 2017 plans, together with the shift to SPOE (minimizing the likelihood of grounds for early termination), are meant to demonstrate that the failure of a G-SIB with a large derivatives position can be accomplished without exacerbating systemic risks.

Resolvability as a BAU consideration

Incorporating resolvability into BAU is one of the ultimate goals of resolution planning, and one of the toughest challenges. The plans indicate that the banks have operationalized this goal through the adoption of key processes and policies, examples of which include development of management information systems (MIS) and reporting capabilities, incorporation of resolution-friendly terms in all vendor contracts, identification of key personnel along with a framework to retain them in resolution, and development of governance playbooks to ensure that governing bodies understand their responsibilities and are prepared to execute them.

The public sections also demonstrate that the banks are layering in a resolution perspective to all aspects of capital and liquidity planning. For example, some G-SIBs are maintaining a capital structure that facilitates the resolution strategy, including subordinated debt that counts toward Total Loss Absorbing Capacity (TLAC) requirements,[14] and incorporating resolution-related terms and disclosures into capital instrument offering documents.

Resolution planning is also driving changes to BAU monitoring practices, as several of the G-SIBs stated that they have developed or enhanced many of their existing MIS to track their service delivery model, financial models, key personnel, vendor contracts and inter-affiliate SLAs, and the application of their LER criteria. All of these changes combined indicate that resolvability is now an additional aspect of risk management and a consideration for all senior management, not just a small group of individuals working on resolution planning.

What's next?

The public sections indicate that the banks have subjected various elements of their 2017 plans to review and challenge, but it will ultimately be up to the Agencies whether the plans are truly credible. Although the last several review periods have been longer than the banks would like, the recent Treasury report on financial regulation called for limiting the feedback period to six months and extending the resolution planning cycle to every other year.[15] The Agencies may be prepared to provide faster feedback than they have historically because they have engaged in substantial dialogue with the G-SIBs throughout the preparation of the plans, although we could see some delays due to the significant leadership changes expected at both Agencies within the next six months. Most importantly, the Fed may wait for the new Vice Chair for Supervision to be confirmed and brought up to speed before issuing any feedback.

Even with new leadership in place, we expect this round of feedback to at least come with potential areas for enhancement relative to the heightened expectations in the 2017 guidance. Going forward, as the bar for the plan requirements stabilizes, it is likely that the Agencies' will want to supplement the plan reviews with testing. We expect that the Agencies will encourage banks to perform internal testing, then use those tests to identify and address areas ripe for improvement. In addition, the Agencies are likely to test select capabilities through horizontal reviews, as has been done in the past. It is likely that horizontal testing, if done, would be focused on key areas of priority interest to the Agencies, such as financial modeling or governance. Another example of a potential test could come out of another best practice from one of the G-SIBs which highlighted an exercise to prove that it could produce all the information necessary to support a bankruptcy filing within 48 hours.

Aside from making sure that they are able to prove claims in their resolution plans in case of tests, banks may consider spending the feedback waiting period exploring opportunities to automate or otherwise improve the efficiency of the capabilities built during the past few years under tight resolution planning deadlines.

Appendix A: Key background

Resolution plans, also referred to as "Living Wills", are required by Dodd Frank and a critical component of the goal to end "Too Big To Fail." More than 100 firms, consisting of all banking companies operating in the US that have more than $50 billion in total assets plus certain non-bank systemically important financial institutions (non-bank SIFIs), are required to file resolution plans.

The 2011 165(d) rule that implements the resolution planning requirement of Dodd Frank includes significant penalties for filers that are unable to remediate deficiencies leading to a non-credible resolution plan. The Agencies may impose more stringent capital, leverage, or liquidity requirements, or restrictions on the growth, activities, or operations of the company, and, if the deficiencies have not been remediated within two years, to require to bank to divest assets or operations.

The plans leverage three foundational elements that are defined terms for resolution planning and that are the main focus of resolution planning efforts:

Foundational element	Description
Core Business Lines (CBLs)	Those business lines, including associated operations, services, functions and support, that, upon failure would result in a material loss of revenue, profit or franchise value
Critical Operations (COs)	Operations identified by the Agencies, including associated services, functions and support, the failure or discontinuance of which could pose a significant threat to the financial stability of the United States
Material Entities (MEs)	A subsidiary or foreign office that is significant to the activities of a critical operation or core business line

Appendix B: Key plan metrics 2012-2017

The following table compares several key (and measureable) attributes of the 2017 public sections to the first submission in 2012 or 2013 and the most recent submission in 2015. As is evident by the number of pages, all public sections increased significantly from both benchmarks. In contrast the trend in the number of CBLs is less clear. This is, in part, attributable to the discretion provided by the rule to leave it to the banks to determine how best to aggregate their business activities. After the initial submission, several firms disaggregated their original core business lines into more, but smaller businesses, albeit without meaningful transformation of their business mix. Other banks designate fewer, but larger CBLs, but provide additional information on multiple sub-businesses that comprise each CBL. All but one of the banks have a greater number of material entities in 2017 than in 2012; we believe this reflects a number of factors including enhanced analysis into interdependencies over the past few years and the creation of new service entities to enhance operational continuity.

	# of pages			# of CBLs			# of MEs		
Banking company	2012	2015	2017	2012	2015	2017	2012	2015	2017
Bank of America	42	63	87	5	17	17	7	17	17
Bank of NY Mellon	24	68	121	4	3	4	14	15	18
Citigroup	31	102	125	15	12	14	17	29	27
Goldman Sachs	32	86	117	2	2	2	22	18	19
JPMorgan Chase	31	53	170	30	26	27	25	33	30
Morgan Stanley	20	60	108	3	3	3	18	17	27
State Street	22	55	70	2	2	2	11	16	21
Wells Fargo	28*	38	66	8*	5	4	5*	5	11

Endnotes

1. The G-SIBs are also known as part of the “Wave 1” banking companies, a category which also includes four Foreign Banking Organizations (FBOs) that have significant US operations. The US G-SIBs’ plans were the only ones due on July 1, 2017. The next resolution plans for the Wave 1 FBOs were postponed until July 1, 2018 to allow them time to incorporate additional guidance released by the Agencies in March 2017. For more information, see PwC’s *First take, Ten key points from regional bank resolution feedback and FBO guidance* (March 2017). The remaining filers are often referred to as “Wave 3” or “December filers”; they must file their next resolution plans by December 31, 2017. This group consists of 16 mostly regional banking companies that must file their 2017 resolution plan by December 31, 2017 and 84 FBOs with more limited US operations that are permitted to file a reduced content plan. The next resolution plan required of the two non-bank SIFIs is not due until December 31, 2018. For more information, see PwC’s *First take, Five key points from the Agencies' FBO resolution plan announcements* (June 2016).
2. The 2017 plan is the fourth resolution plan for Wells Fargo; fifth for the seven other G-SIBs.
3. See PwC’s *First take, Ten key points from Agencies' resolution plan feedback* (April 2016).
4. While the banks were given short timelines to correct the deficiencies, their remediation filings have been reviewed and accepted by the Agencies. Four of the five banks remediated all their deficiencies by October 1, 2016; Wells Fargo remediated its last deficiency by March 31, 2017. See PwC’s *First take, Ten key points from the US G-SIBs' resolution plan progress reports* (October 2016).
5. See the *First take* in note 3. The Agencies defined a Resolution plan Assessment Framework which established baseline expectations and a means by which firms could be cross-compared in a consistent manner. This was also reflected by the Agencies change in approach to reviewing plans.
6. The most critical leadership changes will be 1) filling the vacant Fed Vice Chair of Supervision seat (for which Randal Quarles was formally nominated last week) 2) Fed Chair Janet Yellen’s term expiring in January 2018, and 3) FDIC Chairman Martin Gruenberg’s term expiring November 2017 (James Clinger was nominated for this role, but withdrew from consideration last week).
7. In SPOE, the capital and/or liquidity of the operating entities is replenished by the parent company, which averts the failure of any operating entities but serves as a catalyst for the Parent to file bankruptcy. See PwC’s *Regulatory brief, Resolution: Single point of entry strategy ascends* (July 2015).
8. Among other requirements, G-SIBs were expected to model for each material entity the amount of capital and liquidity necessary to execute the resolution strategy (often referred to as Resolution Capital Execution Needs (RCEN) and Resolution Liquidity Execution Needs (RLEN)).
9. See the *Regulatory brief* in note 7.
10. Goldman Sachs indicates that its strategy is consistent with SPOE but, in addition to the parent filing bankruptcy, two additional subsidiaries are expected to file bankruptcy as well.
11. In 2012, the Agencies required that the resolution strategies assume the failure of all material entities, including those that would be unlikely to fail under even the most extreme circumstances (generally legal entities providing only limited or discrete internal services). Beginning in 2013, the Agencies allowed for greater flexibility, so long as the banks could support their assumptions.
12. These are often referred to as contractually binding mechanisms, secured support agreements, or support agreements paired with security agreements.
13. The ISDA protocol limits early termination rights during a resolution or bankruptcy for derivatives contracts.
14. See PwC’s *First Take, Fed's final rule on TLAC* (December 2016).
15. The recommendation for biennial submissions was endorsed by Fed Governor Jerome Powell and FDIC Chair Gruenberg. See PwC’s *First take, Ten key points from Treasury's first financial regulation report* (June 2017).

Additional information

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