

Regulatory brief

August 2013

A publication of PwC's financial services regulatory practice

Living wills: Global resolution remains a reach

Overview

Progress on recovery and resolution planning has resulted from national efforts aimed at preserving domestic financial stability and from the work of international bodies focused on global financial stability. In the US, the Dodd-Frank Act has required systemically important financial institutions to submit annual resolution plans under rules issued by the Federal Reserve (FRB) and the FDIC. Other countries are also beginning to require plans from their largest financial institutions, but progress has been uneven resulting in differing standards that have presented complications for global firms.

The Financial Stability Board (FSB) has been developing common standards for national regimes, with the blessing of the G20. The FSB took its latest step in July by publishing three final guidance papers¹ (Guidance) to assist national regulators and firms in implementing recovery and resolution planning requirements.² First released for public consultation last year, the Guidance builds on the FSB's previous "Key Attributes of Effective Resolution Regimes for Financial Institutions" (Key Attributes), which required home and host authorities to maintain Crisis Management Groups (CMGs) to set recovery and resolution strategies coordinated across jurisdictions for each Global Systemically Important Financial Institution (G-SIFI).

Taken together with the Key Attributes, the Guidance now forms an initial global framework for recovery and resolution planning. The following are the key takeaways from our perspective:

- While most CMGs have been formed, more needs to be done to establish Cross Border Co-Operation Agreements (COAGs) to allow them to work efficiently and effectively.
- Much work remains with respect to the Single Point of Entry (SPE) versus Multiple Point of Entry (MPE) resolution approaches. Decisions with respect to these resolution strategies may end up being firm-specific (based on the jurisdictions in which the firm operates), blending the approaches. Regardless, the Guidance furthers the view raised by both the FRB and the Bank of England (BoE) that additional clarity in fleshing out issues associated with the different approaches is needed.

¹ See FSB's *Recovery and Resolution Planning for Systemically Important Financial Institutions*: (i) Guidance on Developing Effective Resolution Strategies; (ii) Guidance on Identification of Critical Functions and Critical Shared Services; and (iii) Guidance on Recovery Triggers and Stress Scenarios (July 16, 2013).

² For nonbanks, the FSB proposed draft guidance on August 12th regarding implementing the Key Attributes. The draft guidance discusses (i) the resolution of Financial Market Infrastructures (FMIs) and systemically important FMI participants, (ii) the resolution of insurers, and (iii) client asset protection in resolution. This draft guidance will be the subject of a future PwC *Financial Services Regulatory Brief*.

- Identifying and publicly disclosing the quality and location of a firm's loss absorbing capacity (LAC) is a new concept, which goes much further than current national laws. It is also another reason for companies that are presently legal entity agnostic in conducting business to give more consideration to their legal entity management, including evaluation of booking models and centralized funding models (and, by extension, their transfer pricing methodologies). With the potential for more disclosure, the installation of systems to more fully automate legal entity reporting may be a good investment, especially to the extent that G-SIFIs may need to produce such reports more frequently.
- More perspective from the FSB on dealing with cross-border provision of shared services is needed. Although the Guidance highlights several potential critical functions, it does little to provide needed color relating to the problems that could arise from the provisioning of shared services across jurisdictions and legal entities.
- The Guidance places considerable emphasis on triggers for consideration of recovery actions. G-SIFIs should take a hard look at their triggers and the governance around them. For example, for which entities are they operative? Who is monitoring the legal entity metrics and trends? In a world where capital and liquidity cannot flow so freely throughout an organization, triggers will likely need to be revisited.

This new FSB framework does not have the force of law and is only advisory; however, it indicates a set of standards that individual countries have agreed would be beneficial to preventing any single financial institution from being "Too Big To Fail." In certain areas, however, the FSB may monitor and report to the G20 whether national measures are adhering to the agreed international framework.

This **Financial Services Regulatory Brief** places the Guidance in context, explains its importance, and provides our view of its key points.

Background of the FSB's framework

The FSB was established to coordinate at the international level the work of national financial authorities and international standard setting bodies towards developing and implementing effective regulatory, supervisory and other policies in the interest of financial stability. It brings together national authorities responsible for financial stability in 24 jurisdictions, international financial institutions, sector-specific regulators and supervisors, and experts from central banks.

In 2011, the G20 endorsed the FSB's Key Attributes, the foundation of the Guidance, which sets out twelve essential features that should be part of the resolution regimes of all jurisdictions.

1. Scope (any financial institution that could be systemically significant or critical if it fails)
2. Resolution authority
3. Resolution powers
4. Set-off, netting, collateralization, segregation of client assets
5. Safeguards
6. Funding of firms in resolution
7. Legal framework conditions for cross-border cooperation
8. Crisis Management Groups
9. Institution-specific cross-border cooperation agreements
10. Resolvability assessments
11. Recovery and resolution planning
12. Access to information and information sharing

The Key Attributes require home and key host authorities of all G-SIFIs to maintain CMGs with the objective of enhancing preparedness for, and facilitating the management and resolution of, a cross-border financial crisis affecting a G-SIFI. CMGs should include the supervisory authorities, central banks, resolution authorities, finance ministries and public authorities responsible for guarantee schemes of home or host jurisdictions that are material to its resolution and should cooperate with authorities in other jurisdictions where firms have a systemic presence.

The Key Attributes also require the development of a resolution strategy for G-SIFIs that establishes an approach for resolving the failing firm in a way that protects its critical functions, government funds and systemic stability, and achieves other relevant resolution objectives. The resolution strategy is a key component of the overall resolution plan required under the Key Attributes.

Why does the FSB guidance matter?

In an area as complex as developing national and international standards for resolution of G-SIFIs and other large financial institutions, there is often the temptation to try and arrive at a grand solution, which inevitably leads to frustration and stalemate. To its credit, the FSB has taken a building block approach to

developing consensus where possible and to identifying areas where more work or flexibility will be needed to achieve pragmatic cross-border cooperation. Its standards thus represent the best official global thinking to date of what is required and what questions need to be asked when considering the scope and granularity of recovery and resolution plans.

Being heavily invested in the FSB with senior leadership representation on key committees, the US and UK regulators have a special interest in its framework being implemented globally and integrated with their national approaches. For example, the FSB's Cross-Border Crisis Management Group is chaired by Christine Cumming, First Vice President of the Federal Reserve Bank of New York and, the FSB Resolution Steering Group is chaired by Paul Tucker, Deputy Governor of the BoE.

G-SIFIs which are already subject to cross-border regulation by home or host regulators must consider the added dimension of the Guidance and Key Attributes, which form an additional source of quasi-official regulatory expectations and point to the future state of resolution requirements and expectations. There will be some convergence under the Guidance across national regulators as their resolution regimes evolve.

It is becoming clear from the many public statements over the last year that public officials intend to use their own national recovery and resolution regimes as a framework to introduce individual policy measures in the supervision of individual G-SIFIs in their own country, and they will look to the Guidance. In the press release which accompanied the release of the Guidance, BoE Deputy Governor Paul Tucker said:

Key jurisdictions are well on the way to having the necessary legislative regimes in place. Resolution strategies are being framed in line with the FSB's Guidance Papers. Next steps will need to include regulatory measures to remove impediments and changes to firms' financial or organizational structure where necessary.

While this evolution occurs, G-SIFIs will need to take into account the Guidance in addition to the rules of their national regulators. So, for example, while not all of the measures contained in the Guidance are contained in or are completely consistent with Dodd-Frank, they still must be considered in preparation for G-SIFI discussions with their CMGs.

Any G-SIFI that is required to submit recovery or resolution plans, or to provide information to a national regulator for that regulator to prepare a resolution plan, should consider the FSB's releases. The Guidance and Key Attributes contain statements setting out the intended direction of future supervisory and enforcement activity and individual policy measures contained in the FSB framework which are not (yet) incorporated into existing national regimes. Taken together, they contain a single source of globally agreed regulatory policy on recovery and resolution plan requirements.

The Guidance

Below we identify certain key features of each of three individual papers that make up the Guidance and our view of why the features matter. The three papers address the following:

1. Effective Resolution Strategies
2. Critical Functions and Critical Shared Services
3. Recovery Triggers and Stress Scenarios

Effective Resolution Strategies

Two features stand out in this part of the Guidance as they differ substantially from the reality of what has happened at local and cross-border levels in the three years since Dodd-Frank was passed. The first is that the resolution strategy is envisioned as being supported by "a more detailed operational resolution plan." The second is that resolution strategies should be supported by institution-specific COAGs.

The Guidance suggests that a firm's operational resolution plan or COAG should specify what conditions, scenarios, and circumstances are necessary for home and host regulators to harmonize their efforts, or "refrain from taking independent action," and execute the group-wide resolution strategy. Achieving regular and effective co-operation between home and host regulators is, of course, a major challenge. These ideal aspirations of the FSB are far from reality at this point, as regulators have yet to even consistently agree to disclose respective resolution plans between themselves (although the FSB would like to make certain information more available to the public, as discussed below).

There is no international consensus nor a national set of laws regarding recovery and resolution planning that specifically requires the identification, use or preference of either a SPE approach (in which resolution powers are

applied to the top of a group by a single national resolution authority) or a MPE approach (in which resolution tools are applied to different parts of the group by two or more resolution authorities in a coordinated way). Yet these terms have become common parlance for senior regulators on the global stage. The Guidance sets out a series of questions for regulatory authorities to determine the most appropriate of these two strategies for their firms. G-SIFIs should assess their own strategy against each of the questions set out in the guidance.

It is worth noting, however, that in the US there is currently an expressed regulatory preference for a SPE approach for large US firms, under the Orderly Liquidation Authority of Title II for nonbank financial firms. Yet, at the same time, the FRB appears to favor applying a host country MPE approach to large foreign banks in the US, as it has proposed that large foreign banks with a material presence in the US be required to establish Intermediate Holding Companies to facilitate US resolution,³ even if the home authority for a foreign bank prefers a global SPE approach. Other host jurisdictions would be tempted to follow suit to preserve their authority and prerogatives. This brings to the fore a key question asked in the Guidance on the suitability of the SPE approach – will host authorities identify the conditions under which they would be prepared to refrain from taking action and rely on the home authorities to implement an SPE resolution?

The Guidance sets out in detail what the FSB considers to be the necessary elements for a complete and coherent strategy, which includes:

- The specific location (e.g., in parent company or subsidiaries), position in the creditor hierarchy, amount and availability of adequate LAC to help assist with the orderly wind-down or recapitalization of a failing institution
- Legal and operational firm structure that supports effective resolution under the chosen strategy so that critical functions can be maintained during resolution
- Funding arrangements, resolution powers of home and host authorities, and cross-border coordination and co-operation
- Recovery activities prior to resolution, and “fall-back” provisions post-resolution when the preferred strategy cannot be implemented but critical functions must still be maintained

The sting in the tail comes in the final section of the Guidance paper, entitled “Disclosure to the Public.” The unusual intent of the Guidance to make more information publicly available is new and more aggressive than what is currently in effect. The FSB advises that national authorities “may consider disclosing, or requiring firms to disclose, the amount, location, nature of the LAC on an individual entity basis, including its position in the creditor hierarchy.” The FSB further explains that “such disclosure could help adjust market expectations of the risk of loss, facilitate better pricing of credit risk, and reduce creditor uncertainty about likely recovery should the firm enter resolution.”

The future direction of travel for resolution planning is set. The desire is to reveal the nature of the LAC as to whether it is equity or subordinated debt, senior unsecured debt, or other unsecured and uninsured liabilities. In addition, the quality of instruments comprising the LAC and where it is held within the firm (i.e., at the parent, subsidiary or branch levels) is raised as an important consideration. Limits on cross-holdings and concentration limits on the nature of investments in LAC by the G-SIFIs would be a significant departure over and above existing national regimes. Creditor hierarchy and the application of bail-in provisions are not, however, going away.

Critical Functions and Critical Shared Services

The Guidance distinguishes between “critical functions” and “critical shared services.” The former are activities performed for third parties where failure would lead to the disruption of services that are vital for the functioning of the real economy. The latter are defined as activities within a firm or outsourced to third parties where failure would lead to the inability to perform critical functions (and therefore lead to the disruption of functions vital to the real economy).

The US rules define “critical operations” to include both concepts – critical operations means operations and “associated services, functions and support” which could pose a threat to US financial stability upon failure. This is an area where the national resolution regime in the US has outpaced the FSB. Both the FRB and the FDIC have already produced an extensive confidential list of critical activities and notified the majority of banking organizations of what the two agencies have jointly designated as the firm’s critical operations.

³ See PwC’s *Financial Services Regulatory Brief, Foreign Banks: Hope is not a strategy – Time to act* (July 2013).

The Guidance does, however, present a useful three-step approach with which G-SIFIs can measure or re-visit their own approach to determining a critical function or shared service. The three steps are:

- Impact Assessment – analysis of sudden discontinuance of the function
- Supply Side analysis – evaluation of the existing market that the function operates in
- Firm-Specific test – impact of the failure of a specific G-SIFI that performs the function

Questions relevant to the analysis are set out in the Guidance and not surprisingly focus on the nature and extent of the activity, nature of customers and stakeholders, impact on customers and other market participants, impact on the financial services markets infrastructure (e.g., payment or settlement systems) and any other markets.

Factors relevant to the recovery and resolution of such functions revolve around a number of tests. For example, concentration and substitutability are key questions relevant to the supply side analysis. For functions which are highly concentrated, then market share, dominant shares of other market players, and the risk of those players failing become more relevant. Substitutability is of course also a consideration, particularly if the institution can evidence whether one single provider or multiple providers would be able to take on the activities of the function without significant disruption to customers and the wider market infrastructure.

Finally, there is little detail on the provision of cross-border shared services and dependencies on IT systems which are housed in other countries and are owned by different legal entities. As this was the cause of much disruption and dislocation in the immediate collapse of Lehman Brothers, it is perhaps disappointing that the FSB has been unable to provide further guidance on delivering measures for improvement. On a more positive note, the Guidance does deliver some new material of how it sees the viability of individual functions (e.g., payments, clearing, custody and settlement), and G-SIFIs should revisit how their approach compares against the Guidance.

Recovery Triggers and Stress Scenarios

There is little, if any, controversy in the Guidance on recovery triggers and stress scenarios. The aim of triggers in recovery planning is to enable firms to maintain or restore financial strength and viability before regulatory authorities see the need to intervene or enforce recovery measures. The public consultation produced some modification to the previously published

guidance, and it has now been clarified that the FSB expects that when individual recovery triggers are met or breached, then a full recovery plan process is not automatically required. Rather, a prompt escalation to senior management should ensure that a discretionary response is delivered tailored to the specific situation.

The Guidance sets out what the FSB expects recovery plans to contain: potential vulnerabilities due to its business model, interconnections and risk profile; quantitative and qualitative criteria that define a “trigger” event; options to manage firm-specific (i.e., idiosyncratic) and market-wide (i.e., systemic) stress; stress scenarios which address both capital shortfalls and liquidity pressure; and analysis of the impediments that could impact the execution of a recovery plan.

The FSB describes the industry taxonomy of the key three aspects of recovery planning:

- Quantitative triggers: e.g., ratings downgrades, credit risk limits, and increased collateral requirements
- Qualitative triggers: e.g., resignation of a CEO and requests from counterparties for early termination
- Early warning indicators: e.g., negative trends in business-as-usual driving indicators towards triggers

In addition, there is guidance on the amount and combination of the minimum level of acceptable stress scenarios that a G-SIFI is typically expected to deliver in a comprehensive recovery plan, although inevitably each institution will differ given the individual guidance of its relevant home of host supervisory authority. It is clear that at least one market-wide scenario and one firm-specific should be delivered individually and in combination of the two events taken together. The range of time periods covering the stress events and recovery actions should also include both a slow moving and fast moving scenario of potential financial crisis.

Reverse stress testing (i.e., assuming the failure of the business and identifying the circumstances in which failure occurred) is also highlighted as an effective measure to consider. It is seen by the FSB as a starting point for developing scenarios to test the effectiveness of the range or “menu” of recovery options. The critical components of reverse stress tests include the identification and description of the point of non-viability in both quantitative and qualitative terms based on a default or resolution scenario. This last point is one which signals the future linkage of recovery and resolution plans.

Additional information

For additional information about PwC's Financial Services Regulatory Practice and how we can help you, please contact:

Dan Ryan

Financial Services Regulatory Practice Chairman
646 471 8488
daniel.ryan@us.pwc.com

Alison Gilmore

646 471 0588
alison.gilmore@us.pwc.com

Contributors: Graham O'Connell, Sharon Haas, Nathan Kiel, Scott Levine, Michael Malone, and Gary Welsh.

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