FS Regulatory Brief

Resolution Planning – New guidance, more time, no specificity

April 2013

Overview

On April 15, 2013, the Federal Reserve and the FDIC jointly released guidance to the eleven Category 1 financial institutions that submitted resolution plans in 2012 and are required to submit their Version 2.0 plans this year ("the firms"). Although the guidance reiterates some of the existing requirements of the joint Federal Reserve and FDIC rule under section 165(d) of Dodd-Frank ("the rule"), the guidance does not supersede the rule.[1] Rather, firms must follow the rule in addition to the guidance when preparing their Version 2.0 plans, while also abiding by the limited information contained in the regulators' so called "completeness letters" issued to certain firms in November 2012.

The recent guidance changes regulatory expectations in the following key ways:

- Provides a new format for the resolution plan, including an overarching and concise narrative section.
- Details new alternative resolution strategies.
- Significantly expands resolution plan content by requiring:
  - Details of the governance process for filing bankruptcy and actions that could be taken before bankruptcy.
  - Discussion of five key obstacles to resolution including multiple competing insolvencies, global cooperation, operations and interconnectedness, counterparty actions, and funding and liquidity.
  - Consideration of "adverse" and "severely adverse" economic scenarios.
  - Inclusion of additional Material Entities (where applicable).
  - Appears to incorporate non-US activities, in addition to US activities.

Although these points make resolution plan preparation more actionable, they also increase supervisory expectations for what constitutes a "credible" plan. Category 2 and Category 3 financial institutions can also glean insight from them into the regulators' priorities for their resolution plans (due this year), paying particular attention to the requirement for a concise narrative. The key take away here for all filers is that the process is becoming less academic and more "real world."

We believe the guidance will require significant additional effort by the firms in order to prepare their 2013 plans. The amount of work will vary by institution depending on the extent of analysis and documentation they provided in 2012. In recognition of this needed effort (and the lateness of the guidance), the regulators granted a three month extension for filing their plans, from July 1st to October 1st.

This **FS Reg Brief** (a) analyzes the new guidance's key points, and (b) offers our view that further written regulatory detail is unlikely to be provided in the near term because of the guidance's link to the Too Big To Fail debate in Washington and because of lack of agreement between the regulators.

[1] The guidance is specific to the joint rule. For filers with covered IDIs under the FDIC rule, all applicable requirements in 12 CFR Part 360 must also be met.

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Analysis of the guidance

New format and "narrative"

In 2012, the regulators issued a standard format that the firms had to follow for submitting their resolution plans. The new guidance is focused on making resolution plans more readable and understandable for the regulators. For example:

- There appears to be a desire to address resolution strategy more holistically, early in the document in what regulators call a "Narrative".
- The Narrative is expected to be concise and to focus on the strategic analysis of resolution, and any corresponding impediments or obstacles to resolution. The plan's appendices should contain sufficient detail and analysis to support the strategy.
- In an effort to eliminate redundancies in the plan, detail and analysis that supports multiple areas can be cross-referenced.
- Unchanged portions of the 2012 filing can be incorporated by reference in the 2013 plan. While this appears to be a positive development, in practice it may not work; we believe that too many references to the prior submission will reduce plan readability. It is advisable that references to the 2012 plan be attached as appendices in the 2013 plan.

The guidance also affords firms considerably more latitude in how they present the contents of their plan. We believe these changes in format increase the plan's complexity because the firms must consider multiple sets of guidance: (i) the rule; (ii) the IDI rule (where applicable); (iii) the new guidance; and (iv) formal and informal firm-specific feedback received on the initial submission (including the "completeness letter") and subsequent FAQ guidance (as it becomes available).

While the new guidance mandates revised presentation and, by implication, relief from the original standard format issued by the regulators, firms may still elect to leverage the standard format for purposes of structuring appendices or ensuring completeness. The guidance also stipulates that all information in the appendices must be relevant to and clearly referenced in the Narrative, or be required by the rule, suggesting the retirement of unnecessary data and documents.

In accordance with the rule, 2013 plans must still have a public section and a confidential section that contains an executive summary, narrative, appendices and other informational requirements. The new guidance encourages a more streamlined executive summary than was submitted initially, containing a concise summary of the strategy and how firms will address any obstacles to resolution. Finally, the guidance focuses on Material Entities and Critical Operations, with only limited discussion of Core Business Lines. However, the firms must still perform their analysis of Core Business Lines, as it is required by the rule.

New alternative resolution strategies

The guidance also specifies alternative or additional strategies that the firms may utilize in their 2013 resolution plan. Guidance in 2012 included the bankruptcy or failure of the covered company and all Material Entities. For 2013, this option remains, but the firms are also provided options for addressing:

- A scenario in which only the parent company fails (Single Point of Entry).
- A scenario in which the parent holding company or US parent fails, along with a limited number of Material Entities, with other Material Entities surviving.
- A scenario in which the "covered company is compartmentalized" such that the bankruptcy of one or more Material Entities does not result in the failure of additional Material Entities. We believe this applies only to non-US based universal banks which operate in subsidiary structures globally.

This set of options introduces a pragmatic element to the resolution planning process and should enable the firms to concentrate planning efforts. Regulators will likely expect a rigorous demonstration of the feasibility of each strategy option utilized by the firms.

The bankruptcy process and implications for executive and board accountability

In 2012, the firms were required to describe applicable resolution regimes and the steps generally taken to initiate bankruptcy proceedings and execute resolution strategies. For 2013, the regulators are seeking additional details related to: (i) the governance and escalation process the firms have in place to determine when to file for bankruptcy, and (ii) the discussion of any actions that could be taken in a "runway" period of not more than 30 days immediately preceding the bankruptcy filing, "… including the sale, liquidation or spin-off of any assets or business lines."

We believe this section is particularly important because it emphasizes executive and board accountability for ensuring rapid and orderly resolution. Depending on a firm's descriptions of its existing contingency planning and crisis management governance framework and processes, meeting this section's requirements could require meaningful additional work.

For 2012 plans, firms were guided to assume that no recovery actions were successful and that all Material Entities must fail and enter applicable resolution regimes. The 2013 guidance in contrast allows for the possibility that some Material Entities do not fail, but firms should expect to demonstrate significant evidence for assuming non-failure. With this allowance, the guidance implicitly acknowledges the connection between recovery (and other contingency) planning with the resolution plan, and signals the need for firms to:

- *Describe the information used to determine that recovery is not feasible and that filing for bankruptcy and entering resolution is an appropriate course of action.* The guidance requires documentation of the factors or metrics that will be monitored and used in the escalation and decision making process. Requiring documentation of metrics to govern the escalation process provides an element of discipline to crisis management that clearly requires engagement from increasingly senior levels of management and ultimately the Board of Directors, making it difficult to ignore or discount the potential seriousness of early warning signals.
- *Link recovery plan analytics and resolution plan analytics.* In this regard, we believe the term "runway period" refers to the point at which the firm determines that failure is likely to be inevitable and begins to take preparatory actions to filing for bankruptcy (or entering into an insolvency regime). The new guidance introduces the possibility that firms may take (or continue) certain actions during this period, including the sale, liquidation or spin-off of assets or business lines. However, since this period is limited to no more than 30 days, we believe that such activities would be those connected to resolution strategies, including sales that would be consummated following a bankruptcy filing.

The guidance goes a step further by requiring a discussion of crisis governance at not only the consolidated level but also at each of the Material Entities. This underscores the increasing emphasis being placed by the regulators on legal entity governance, not only in resolution but also during business as usual. The need to establish or improve parallel consolidated and standalone governance structures for a firm's Material Entities could require substantial effort initially and also to maintain during ordinary course.

This section of the plan should include a plain-English version of legal preparations and a description of the tactical actions that could be taken to result in a more orderly failure from start to finish. There should be a pragmatic linkage between the governance around the bankruptcy filing decision and the related tactical actions, linked to the firm's strategy. Among the many issues to be discussed is the preferred sequencing of the Material Entities entering their respective resolution regimes, accompanied by a discussion of the benefits and costs of a different sequencing.

Also new for 2013 is a required analysis of the possible actions taken throughout bankruptcy administration. The guidance calls for consideration and documentation of

numerous aspects of the bankruptcy, including: the process for arranging debtor-in-possession financing; consents to the use of cash collateral; whether it is necessary to obtain agreements from counterparties to forego contractual termination rights (and the process for doing so); and whether it is necessary to obtain consents from executory contract counterparties to continue access to both internal services (such as MIS systems) and external services (such as financial market utilities ("FMUs")).

Finally, we believe significant effort is required to reflect the application of the bankruptcy process to the firm's specific strategy. Consistent with the rule, the plan needs to include an estimate of the time required to accomplish each major action during bankruptcy and an estimate of the anticipated costs. This requirement is carried to the next step by the guidance's call to project funding needs throughout the duration of the bankruptcy (as further discussed below) and to address the expected treatment of creditors, shareholders, counterparties, and other stakeholders.

Five key obstacles to resolution

The new guidance indicates that firms must discuss, at a minimum, five key obstacles to resolution identified by the regulators. We believe that the additional preparation needed to address these obstacles may be substantial, depending on each firm's business composition and global footprint, and on the approach taken to these items in 2012:

1. Multiple competing insolvencies

Market events (specifically the failure of Lehman Brothers) prior to the passage of Dodd-Frank highlighted the risks associated with inconsistent or conflicting resolution regimes for local subsidiaries of globally active firms. The preamble to the rule states that resolution strategies for the Critical Operations of globally active US-based covered companies and for Material Entities with greater than $50 billion in assets "… should take into consideration the complications created by differing national laws, regulations, and policies."

While the rule required firms to address a scenario where the parent company and its subsidiaries simultaneously entered resolution, the new guidance offers a greater degree of flexibility for a firm to discuss potentially more realistic scenarios involving the phased entry of various Material Entities into resolution. It also allows for consideration of whether some Material Entities could avoid entering resolution if the firm as a whole encountered significant financial distress. In these additional failure scenarios, the interplay between competing insolvency regimes due to legal, procedural or timing issues could jeopardize the continuity of Critical Operations performed by the firm. For globally active firms, differences in local jurisdictional insolvency regimes can pose similar difficulties, such as the "ring fencing" of Material Entities.

In addition to considering different resolution paths, the new guidance requires a more in-depth discussion of necessary tactical steps for those paths to mitigate risks to Critical Operation continuity potentially arising from different insolvency processes. Identification of these tactical steps will require detailed analysis of the steps for entry into insolvency and subsequent procedural elements of the resolution regimes applicable to Critical Operations-related entities and the sequencing of those elements across the different regimes. The results of this jurisdictional analysis would then be evaluated to assess their impact on the funding, liquidity, and operational considerations necessary to provide for the continuity of the critical operation.

The requirements imposed by the new guidance will add complexity to resolution strategies identified for cross border Critical Operations. These strategies will need to more fully examine the potential implications of "ring fencing" or other impediments to asset and funds flows, movement of customer assets and operational issues stemming from the use of service providers located in foreign jurisdictions. To the extent that this analysis suggests that identified impediments could result in heightened risk to the financial stability of the US or materially diminish the value of US operations, the firm could be

required to make changes to its business model to mitigate those concerns.

2. Global cooperation

Firms that submitted plans in 2012 were required to describe the regulatory and resolution regimes governing foreign operations. Based on the new guidance, regulators are expecting this analysis to reflect only existing law and regulations – and not to anticipate changes in resolution authorities and cooperation agreements.

The guidance provides that firms should not anticipate significant changes to the legal and regulatory frameworks for foreign jurisdictions where they operate (such as harmonization of standards and processes). Rather they should assess the existing resolution regimes in those countries, and identify structural issues that could result in obstacles to a coordinated resolution of the firm. Although local regulators may seek to cooperate with the home country regulator in executing a global resolution strategy, they may be required to prioritize domestic requirements and may not have the authority or capacity to fully cooperate.

Firms will need to consider the downside case where regulators do not cooperate and will need to understand and describe where cooperation or forbearance might occur. They must also describe the impact on the continuity of Critical Operations where cooperation is not possible. To the extent that reduced regulatory cooperation is more likely than not, the guidance appears to require that firms explain possible changes, including potential changes to existing business models, to mitigate the risks associated with this lack of cooperation.

3. Operations and interconnectedness

The regulators have asked the firms to deepen and expand their previous analysis on financial, operational, and external interconnections and interdependencies, as well as provide a significant amount of new information. The regulators define "operations and interconnectedness" as (i) payments, clearing and settlement activities, and (ii) interconnectedness and shared services.

The payments, clearing and settlement activities had been one of the four Critical Operations categories defined by regulators in 2012. This category included wholesale and retail payments, securities clearing and settlement, custody/safekeeping, corporate trust, treasury, and cash management. Previously, the regulators asked firms to identify their key memberships in FMUs and describe the FMU's reaction to the "Covered Company's failure or potential failure". For 2013, the firms must identify their top 20 FMUs and then expand on the specific actions each FMU would take in response to the firm's failure or potential failure. Issues that must be explored include:

- Actions the FMU is required to take upon the insolvency or potential insolvency of a member.
- The extent to which cooperation is assumed to take place between the regulator and the FMU, with the rationale for the assumption.
- Liquidity, margin, collateral and operational back-up plans, and actions that a firm would take if access to an FMU was restricted or unavailable.

Similar to the payments, settlement and clearing section, the interconnectedness and shared services section asks for both greater detail and new information. Plans for 2013 must deepen their description of how financial and operational support activities for Critical Operations would continue in resolution. New needed information relates to identifying key MIS personnel and describing how they would be retained upon the firm's failure, identifying the legal owner of key master data (reference and transactional), and providing detailed process maps/diagrams of the top-tier applications that support the Critical Operations.

2013 plans must also describe at a deeper and more granular level how intercompany services are governed, managed, and priced. Finally, firms must provide a description of projects or actions taken (or planned) to ensure that Critical Operations and services continue in resolution. Actions cited by the guidance include creating bankruptcy remote

entities, moving services into the bank, pre-paying for services, or subsidiarization.

4. Counterparty actions

The rule addresses qualified financial contract activities, particularly those that represent complex interconnections and interdependencies between firms and among affiliated Material Entities. The guidance significantly increases expectations by requiring that potential obstacles arising from expected counterparty actions (especially derivative counterparties) be detailed and, in some cases, be accompanied by a plan to mitigate challenges to an orderly resolution. Considerable additional information is requested on contractual provisions, such as cross-default provisions and guarantees, particularly those that address legal rights and motivations of derivative counterparties leading to and during resolution. The guidance also requires the following:

- Additional substantive detail that describes booking practices and associated collateral; hedging and risk management techniques (especially related to split hedges and loss of intercompany hedging benefits); and other issues that are expected to result from counterparty actions in resolution including the exercise of termination rights. These must all be detailed by Material Entity and jurisdiction, including potential friction among applicable resolution regimes.
- A discussion of the likely impact of contract terminations, close-outs, and unwinds on other entities (such as FMUs) on the financial system and on Material Entity resolution strategies.
- Significant incremental and detailed information on position valuations and management of associated collateral, including the amount, nature, and location of third party collateral by any legal entity; the systems used for collateral management; and a description of how collateral management processes would work in resolution (by Material Entity regardless of where domiciled).

While a discussion of third party and affiliate counterparty behavior leading up to and during resolution is not a new requirement, the guidance specifies numerous specific details that must be included in the 2013 plan. In the aggregate, this obligation is likely to translate into substantial additional information, detailed analysis, and preparation for most firms.

5. Funding and liquidity

Significant information on funding and liquidity was required for the 2012 plan. The new guidance goes further by clarifying the expectation for detailing funding and liquidity by legal entity and jurisdiction, and requiring that that these projections extend through the expected duration of the bankruptcy. For most firms, this mandate will translate into significant additional preparatory work.

Liquidity needs must be projected for each Material Entity, including the identification of the sources of funding. The projections must take into consideration funding that may become trapped in a different jurisdiction as well as the effects of counterparty and customer behavior related to collateral requirements and contingent/guarantee obligations. The required information on funding and liquidity is also extended to each Critical Operation, which adds more challenging information requirements as many designated Critical Operations operate across legal entities and business units.

The guidance also requires a qualitative and quantitative discussion of funding challenges facing Material Entities that have strategies to survive, effectively requiring a funding plan for each. Completion of this section for firms that may not have performed extensive funding projections or developed funding models may be challenging in the time frame established by the regulators.

Adverse and severely adverse economic scenarios

While the 2012 plans only needed to consider failure occurring during a baseline economic environment, the 2013 plans must also consider resolution strategies if failure were to occur under two additional, weaker economic scenarios. The guidance provides clarity about integrating “adverse” and “severely adverse”

scenarios into the plan, and streamlines the macro economic variables to one static set of factors for each scenario (modestly tempering the additional effort required by the rule).

Additional material entities

The scope of Material Entities appears to be significantly expanded by the guidance. As an example, it requires firms to list as a Material Entity any entity that holds collateral in connection with derivatives.

Domestic versus foreign-based covered companies

While the *rule* clearly limits the scope of the resolution plan to US activities or entities that substantially support US activities, a strict reading of the *guidance* appears to bring in non-US activities, including a global derivatives discussion. The lack of clarity around this issue and inconsistent language between the guidance for US domestic firms and the guidance for foreign based firms are significant items for discussion and will likely require further interpretation and discussion with the regulators.[2]

Perhaps in recognition of the evolution of international resolution legislation, the new guidance allows foreign based firms to include a supplemental resolution strategy that incorporates support (extraordinary or otherwise) from its home government, as long as evidence is provided that the assumption of home country support is reasonable.

More written guidance is unlikely

Beyond the guidance, additional written regulatory detail is unlikely in the near term for two reasons. First, resolution planning is linked to the Too Big To Fail ("TBTF") debate in Washington since resolution plans are one of the primary regulatory responses to TBTF. As a result, regulators' efforts in this area inevitably face heightened Congressional and public scrutiny. By issuing their new guidance in a public manner, the agencies conveyed transparency and demonstrated that they are addressing TBTF. It is likely not a coincidence that this new guidance was released the day before the recent House Financial Services Subcommittee hearing on TBTF. Such public transparency does not allow for firm-specific feedback, which is the additional detail firms now need.

Second, the timing of the guidance – nearly 10 months after the firms' original plan submissions on July 1, 2012 and just 2 months before Version 2.0 was originally due – suggests that the Federal Reserve and FDIC are having difficulty reaching consensus on the 2012 plans and could not agree on more detailed and firm-specific feedback. It also implies more generally that they have not agreed on the process to get to a "credible" plan or perhaps even on what "credible" means. The reality of this situation, taken with the outcry for public transparency, is that firms will continue to struggle to get needed details and will have to rely on oral regulatory feedback.

[2] Although it is not fully clear, it appears that the guidance for foreign based firms was tailored from the US domestic firm guidance (using the US domestic guidance as the baseline).

Additional information

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