

# Pressure to act now

## Implications of U.S. Resolution Plans and Credit Exposure Reporting for foreign-owned financial institutions



The U.S. Federal Reserve (Fed) and Federal Deposit Insurance Corporation (FDIC) have announced their proposals for resolution planning, and established a compliance deadline on or about December 31, 2011. Of the estimated 124 “Covered Companies,” a number will be nonbank companies and foreign banks treated as Bank Holding Companies under the International Banking Act. A failure to comply with the new proposals could lead to more stringent capital, leverage, or liquidity requirements or an order to change the operating structure to facilitate an orderly resolution under the U.S. Bankruptcy Code. How will this impact the G20 ambition of creating a level playing field?

On the March 29, 2011 a request was issued for public comment on a proposed rule change designed to implement the Dodd-Frank Act requirements for resolution plans and regular reporting on the nature and extent of credit exposure to significant<sup>1</sup> bank holding companies and significant<sup>1</sup> non-bank financial companies. The intention is to implement the new requirements on or about December 31, 2011, leaving very little time for firms to be in a position to comply.

These proposals are aligned with proposals for legislation issued by the European Commission and similar in approach to certain G20 pilot schemes, but they do not address recovery planning (i.e., the menu of options that a “Covered Company” may take before resolution to address extreme financial stress) which may have implications for any eventual resolution.

### How can KPMG help?

We have extensive experience with assisting banks through the resolution planning process, from scoping to data collection and analysis, determination of resolution strategies, program management, and the application of resolution principles. We can assist you with a cost-effective approach, which is designed to help you meet the regulatory requirements, focuses on retaining the key drivers of value in your operating model, and sets out the key requirements for implementation.

<sup>1</sup> As of date of the alert, the Federal Stability Oversight Council has not published the criteria defining “significant.”

## Which financial services companies will fall within the scope of the proposed rule?

It is estimated that 124 financial services firms will now be required to support the periodic submission of resolution plans to the Fed, FDIC, and Financial Stability Oversight Council (FSOC) that address the rapid and orderly resolution of the firm in the event of material financial distress or failure.

These “Covered Companies” fall into three groups:

- Nonbank financial companies supervised by the Fed
- Bank holding companies with assets of at least US\$50 billion
- Foreign companies that are bank holding companies, or are treated as such under the International Banking Act, with at least US\$50 billion in worldwide assets. The resolution plans and credit exposure reports will cover only the U.S. domiciled subsidiaries and operations.

The inclusion of foreign companies confirms that national authorities recognize the challenges associated with cross-border resolution and may not simply rely on home supervision. Furthermore, according to the UK Financial Service Authority (FSA) “minded to extend the requirement for recovery and resolution plans to include all UK deposit takers, in addition to systemically important firms,” and the European proposals applying to all credit institutions and certain investment firms, resolution planning requirements are likely to vary from jurisdiction to jurisdiction. This further demonstrates the move away from global consistency.

## Deadline for compliance

There is a need for U.S. Covered Companies to act now if they are to meet the minimum information and analysis requirements, as these rules are expected to be finalized, and the 180-day compliance period expires on or about December 31, 2011. Any failure to submit an adequate plan or to remedy the deficiencies identified in the plan could result in more stringent capital, leverage, or liquidity requirements, or possibly restrictions on growth, activities, or operations. If such deficiencies were to remain unaddressed after a two-year period, the Covered Company may be ordered to divest such assets or operations as determined necessary to facilitate an orderly resolution of the Covered Company under the Bankruptcy Code.

It is clear that a proper and consistent process will need to be embedded to facilitate board approval (or a delegate of the board of directors for foreign-based covered companies) on or about December 31, 2011, and consistent, the annual resubmission that is required. The supporting infrastructure also needs to be capable of revising and resubmitting plans within 45 days of any event, occurrence, and change in conditions or circumstances which may have a material effect on the Resolution Plan.

Once submitted, the Fed and FDIC will determine and acknowledge within 60 days whether the Resolution Plan satisfies the minimum informational requirements and should be accepted for further review. If the minimum information is not met, a resubmission will be required within 30 days.

We anticipate an iterative approach to resolution planning over time, and it is possible that the requirements may be modified as the Financial Stability Board (FSB) and other G20 nations formally consult on their national framework and rules.

## Where will the focus of resolution planning be?

Rather than following the more prescriptive UK FSA pilot approach of dividing banking products and services into more than 26 separate economic functions, or adopting European terminology such as “critical functions,” the U.S. proposal requires the resolution plan to address:

- **“Core business lines”** (including associated operations, services, functions, and support) that, in the view of the Covered Company, upon failure would result in a material loss of revenue, profit, or franchise value.
- **“Critical operations”** (including associated services, functions and support) that, in the view of the Covered Company or as jointly directed by the Fed and FDIC upon a failure of, or discontinuance of such operations, would likely result in a disruption to the U.S. economy or financial markets. The Resolution Plan should also address and provide for the continuation and funding of critical operations.
- **“Material entities”** (i.e., a subsidiary or foreign office) of the Covered Company that are significant to the activities of a critical operation or core business line.

The European proposals explore other key resolution concepts such as intra-group financial support during a period of material financial stress, or controversial resolution tools like debt write-down. Furthermore, no specific comment is made on the resolution of bank branches.

## Structure of the resolution plan

Those Covered Companies with significant cross-border operations may face a challenge in preparing a group resolution plan and meeting the differing regulatory expectations across jurisdictions. However, the proposed resolution plan includes:

- **The executive summary** including actions taken to improve the effectiveness of the plan and remediate/mitigate material weaknesses or impediments to effective and timely execution.
- **Strategic analysis** detailing how, in practice, the Covered Company could be resolved under the Bankruptcy Code including analytical support for the plan, and its key assumptions (including economic or financial conditions at the point of resolution).

*Note: other G20 countries may focus Covered Company effort on identifying key separation issues and how these can be addressed with the authorities drafting formal resolution plans that outline the application of resolution regime legal tools.*

*The strategic analysis must identify:*

- A range of specific actions the Covered Company would take to facilitate a rapid and orderly resolution of material entities, critical operations, and core business lines; funding, liquidity, support functions, and other resources, including capital resources, should be identified and mapped to material entities, core business lines, and critical operations
  - A strategy for maintaining and funding critical operations and core business lines during periods of financial distress and into the execution of the resolution plan
  - A strategy in the event of a failure or discontinuation of a material entity, core business line or critical operation, and the actions that will be taken to prevent or mitigate adverse effects on the financial stability of the company and the United States
  - A strategy for ensuring that any insured depository institution subsidiary will be adequately protected from risks arising from the activities of any nonbank subsidiaries of the Covered Company (other than those that are subsidiaries of an insured depository institution)
  - Analytical mapping to demonstrate how core business lines and critical operations can be resolved and transferred to potential acquirers and how these could withstand the failure or insolvency of one or more entities within the Covered Company; however, internal and external service level agreements may need to be re-drafted, and shared service arrangements revised to specify the business services essential for the continued operation of the end-to-end core business lines and critical operations.
- **Corporate governance** structure for resolution planning, explaining how this is integrated into the existing corporate governance structure and processes, and listing the senior management official primarily responsible for overseeing the development, maintenance, implementation, and filing of the Resolution Plan and for compliance with the proposed rule.

For the largest and most complex companies, it may be necessary to establish a central planning function that is headed by a senior management official, reporting to the Chief Risk Officer (CRO) or Chief Executive Officer (CEO), and periodic reports on resolution planning would be made to the board of directors.

Another interesting difference from other G20 pilot schemes is that the proposals do not specifically require comment on the process to prepare and verify the plan, nor any explicit requirement to name the individuals involved with discharging resolution actions. Furthermore, there are no explicit references to the fact that Covered Companies may identify systemic risk issues that the Fed or FDIC may need to address (e.g., systemic risk common to all covered companies and users of common market infrastructure).

- **Overall organizational structure** and related information (i.e., a list of all material entities, jurisdictional and ownership information mapped to core business lines and critical operations).

Other information would include:

- An unconsolidated balance sheet and a consolidating schedule for all entities that are subject to consolidation
- Material assets mapped to entities, liabilities mapped to entities, derivatives, hedges, capital and funding sources, and major counterparties
- Analysis of the effects a bankruptcy filing by a significant counterparty would potentially have on a firm's overall financial condition, including liquidity and capital
- Trading, payment, clearing, and settlement systems that are material in resolution planning.

Covered Companies with foreign operations will need to identify the extent of the risks related to its foreign operations and the plan for addressing such risks (including the complications created by differing national laws, regulations, and policies). This may include mapping core business lines and critical operations to legal entities operating in or with assets, liabilities, operations, or service providers located in foreign jurisdictions and evaluating the continued ability to maintain along with practical steps identified to address weaknesses or vulnerabilities.

- **Management information systems** supporting core business lines and critical operations including legal ownership of such systems as well as associated software, licenses, patents, and other intellectual property. This should address the continued availability of the key management information systems that support core business lines and critical operations both within the United States and in foreign jurisdictions.
- **Description of interconnections and interdependencies** among the Covered Company and its material entities and affiliates, and among the critical operations and core business lines of the Covered Company that, if disrupted, would materially affect the funding or operations of the Covered Company, its material entities, or its critical operations or core business lines.

- **Supervisory and regulatory information**, identifying the Covered Company's supervisory authorities and regulators, including information identifying any foreign agency or authority with supervisory authority over material foreign-based subsidiaries or operations.

In creating the above elements in resolution planning there will be a need to identify and remedy any deficiencies in the processes and systems that collect, maintain, and report the information and other data underpinning the Resolution Plan. Covered Companies may also need to demonstrate their capability to promptly produce the data.

## Structure of the quarterly credit exposure reporting

The credit exposure report sets forth the nature and extent of credit exposures by the Covered Company to significant bank holding companies and significant nonbank financial companies as well as the credit exposures of significant bank holding companies and significant nonbank financial companies to the Covered Company.

Although this new reporting will be aligned with other regulatory reports, no specific detail is provided on the breakdown by market or instrument type.

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