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Regulatory Practice Letter
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Resolution Plans – Second Round "Shortcomings" Identified by Federal Reserve and FDIC

Executive Summary

On August 5, 2014, the Federal Reserve Board (Federal Reserve) and the Federal Deposit Insurance Corporation (FDIC) (collectively, the Agencies) announced they had completed their reviews of the 2013 resolution plans submitted by eleven large, complex banking organizations. The Agencies identified what they jointly termed to be "shortcomings" in the 2013 resolution plans for these eleven firms (referred to as the First-Wave Filers – please see explanation in the Background section) and indicated they will need to be addressed in the firms' 2015 plans to be submitted in July of that year (the 2014 submissions have already been completed). In particular, the Agencies state the July 2015 plans must demonstrate that the firms are making "significant progress" to address all of the shortcomings identified by the Agencies, and that the firms are taking actions to improve their resolvability under the U.S. Bankruptcy Code.

Each of the firms received a letter from the Agencies that addressed shortcomings specific to their own resolution plan. Although the shortcomings of the plans varied across the individual firms, common features identified by the Agencies included:

- Assumptions that the Agencies regarded as unrealistic or inadequately supported, such as assumptions about the likely behavior of customers, counterparties, investors, central clearing facilities, and regulators; and
- The failure to make, or even to identify, the kinds of changes in firm structure and practices that would be necessary to enhance the prospects for orderly resolution.

The Agencies have "agreed that in the event that the [F]irst-[W]ave [F]ilers have not, on or before July 1, 2015, submitted plans responsive to the identified shortcomings, the [A]gencies expect to use their authority under [S]ection 165(d) to determine that a resolution plan does not meet the requirements of the Dodd-Frank Act" (*Dodd-Frank Wall Street Reform and Consumer Protection Act*). Such authority permits the Agencies, following a joint determination, to require resubmission of the resolution plan, and, in the event an acceptable plan is not submitted in a timely manner, to impose more stringent capital, leverage, or liquidity requirements, or restrictions on the growth, activities, or operations of the company, and to order divestitures, if the deficiencies remain uncured.

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Background

The Federal Reserve and the FDIC published a joint final rule in November 2011 that requires U.S. bank holding companies (BHCs), including foreign banks or companies treated as BHCs, with total consolidated assets of $50 billion or more and systemically important nonbank financial companies supervised by the Federal Reserve (together, Covered Companies) to submit plans to the Agencies for their rapid and orderly resolution in the event they suffer material distress or failure (Final Rule). The Final Rule implements Section 165(d) of the Dodd-Frank Act and requires the plans to be submitted to the Agencies periodically though no less than annually. (Please refer to Regulatory Practice Letter 11-22.)

The FDIC separately approved an Interim Final Rule (subsequently finalized in April 2012 and referred to hereinafter as the IDI Final Rule) that requires insured depository institutions (IDIs) with total assets of $50 billion or more (Covered IDIs) to submit resolution plans to the FDIC that could be used in the event of their failure. The IDI Final Rule was promulgated under authorities granted by the *Federal Deposit Insurance Act* (FDI Act) to act as receiver for a failed depository institution. These plans (hereinafter FDI Act Plans) are intended to show the FDIC how a Covered IDI can be separated from its parent company structure and wound down or resolved in an orderly fashion that: gives depositors ready access to their insured deposits; maximizes the return on the sale of assets; and, minimizes creditor losses. Covered IDIs must submit their FDI Act Plans to the FDIC based on the filing date applicable to their parent company.

The Agencies' Final Rule and the FDIC's IDI Final Rule are separate, but intended to be complementary. The two rules share an implementation schedule that is based on the total non-bank assets of each Covered Company, measured as of the effective date of the Final Rule. Only the U.S. non-bank assets of a foreign Covered Company would be considered for purposes of determining the appropriate date for the foreign Covered Company's initial submission (in contrast to its determination as a Covered Company, which is based on total consolidated assets). In particular, the initial submission schedule requires:

- Covered Companies with $250 billion or more in <u>non-bank</u> assets to submit their Dodd-Frank Plans on or before July 1, 2012;
- Covered Companies with $100 billion or more in total <u>non-bank</u> assets to submit their Dodd-Frank Plans on or before July 1, 2013; and
- All other Covered Companies to submit their Dodd-Frank Plans on or before December 31, 2013.

In September 2011, FDIC Chairman Gruenberg said, "We expect that the process of developing these plans – or "Living Wills" – will be a dialogue between the regulators and the firm. It is not a simple "check-the-box" exercise, and it must take into account each firm's unique characteristics. The planning process must also be iterative, especially for the largest and most complicated firms."

The eleven First-Wave Filers were Covered Companies that met the threshold of $250 billion or more in <u>non-bank</u> assets as of November 30, 2011, the effective date of the Agencies' Final Rule.

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Description

2013 Resolution Plan Reviews

The 2013 plans that were the basis for the Agencies' analyses are the second round of resolution plans filed by the eleven First-Wave Filers. They first filed resolution plans in July 2012. After reviewing the July 2012 plans, the Agencies issued guidance in April 2013 that (1) modified certain assumptions the firms were to use in preparing and updating their resolution plans and (2) requested more detailed information on, and analysis of, obstacles to resolvability under the U.S. Bankruptcy Code, including global issues, financial market utility (FMU) interconnections, and funding and liquidity. Firms were also expected to provide more detailed analysis to support the strategies and assumptions contained in their resolution plans. To accommodate these changes, the Agencies extended the time to file the second resolution plans until October 2013.

The Agencies state the April 2013 guidance was largely reflected in the resolution plans filed by the firms in October 2013. However, they also noted what they termed "shortcomings" in all of the second round plans, which were found to share the following common features:

- Assumptions that the Agencies regarded as optimistic, unrealistic, or inadequately supported, such as assumptions about the likely behavior of customers, counterparties, investors, central clearing facilities, and regulators; and
- The failure to make, or even to identify, the kinds of changes in firm structure and practices that would be necessary to enhance the prospects for orderly resolution.

Based on its review findings, the Federal Reserve determined that the eleven banking organizations must take immediate action to improve their resolvability and reflect those improvements in their 2015 plans. The FDIC, based on its review, determined the plans were "not credible and do not facilitate an orderly resolution under the U.S. Bankruptcy Code" and, as such, did not meet the statutory requirements for an acceptable resolution plan under Section 165(d) of the Dodd-Frank Act. A joint determination by the Federal Reserve and FDIC that a plan is "not credible" or does not facilitate an orderly resolution under the U.S. Bankruptcy Code is needed to require a firm to resubmit its capital plan.

Accordingly, the Agencies now expect that the annual plans to be submitted by the First-Wave Filers on or before July 1, 2015, must demonstrate that the firms are making significant progress to address all of the shortcomings identified by the Agencies in their individual notification letters, and that the firms are taking actions to improve their resolvability under the U.S. Bankruptcy Code. As outlined in the Agencies press statement, these actions broadly include:

- Establishing a rational and less complex legal structure that would take into account the best alignment of legal entities and business lines to improve the firm's resolvability;
- Developing a holding company structure that supports resolvability;

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- Amending, on an industry-wide and firm-specific basis, financial contracts to provide for a stay of certain early termination rights of external counterparties triggered by insolvency proceedings;
- Ensuring the continuity of shared services that support critical operations and core business lines throughout the resolution process; and
- Demonstrating operational capabilities for resolution preparedness, such as the ability to produce reliable information in a timely manner.

The individual letters provided to the firms detail guidance specific to the shortcomings in each firm's plan, in addition to the specific and concrete steps each firm must take to improve its resolvability under bankruptcy.

Board Member Statements

The Federal Reserve released a statement indicating that its action to require the First-Wave Filers to address the shortcomings in their upcoming 2015 plans is consistent with the Agencies' joint statement accompanying the release of the Final Rule, where "the Agencies noted that they 'expect the review process [for the plans] to evolve as covered companies gain more experience in preparing resolution plans...There is no expectation by the Board and the Corporation that the initial resolution plan iterations submitted after this rule takes effect will be found to be deficient, but rather the initial resolution plans will provide the foundation for developing more robust annual resolution plans over the next few years following the initial period.'"

In an individual statement, FDIC Vice Chairman Thomas Hoenig offered the following:

- "I recognize that subjecting these most complicated firms to bankruptcy is no simple task and will require enormous effort to accomplish. This is particularly the case today given that these firms are generally larger, more complicated, and more interconnected than they were prior to the crisis of 2008."
- "…while these most complicated firms may have added some capital as a funding source, they have only marginally strengthened their balance sheet to facilitate their resolvability, should it be necessary. They remain excessively leveraged with ratios of nearly 22 to 1 on average. The remainder of the industry averages closer to 12 to 1. Thus, the margin for error and time to default for the largest, most systemically important financial firms is nearly half that of other far less systemically important commercial banks."
- "Despite ongoing efforts at international cooperation, capital flows within multinational financial firms and information flows among authorities remain opaque…Under such circumstances, it would be foolish to assume that countries will not protect their domestic creditors and stop outflows of funds when crisis threatens."
- "The Living Wills before us fail to fully acknowledge these issues and ignores other operational issues. They demonstrate little ability to cope adequately with failure without some form of government support."

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Additional Guidance for BHCs with Less Than $100 Billion in Non-Bank Assets

In a separate but related release, the Agencies announced on August 15, 2014, that they had completed reviews of the initial resolution plans filed by U.S. Covered Companies with less than $100 billion in non-bank assets and foreign Covered Companies with less than $100 billion in U.S. non-bank assets. These firms previously filed their initial resolution plans on December 31, 2013 and the second round plans will be due December 31, 2014.

The Agencies note that each of the 117 firms in this group has received a letter from the Agencies providing "guidance, clarification and direction for their second resolution plans based on the relative size and scope of each firm's U.S. operations."

- Thirty-one firms defined by the Agencies as "more complex" in this asset category will be expected to file a full resolution plan that addresses the "potential obstacles to resolvability" identified in their letters, including global issues, FMU interconnections, and funding and liquidity.
- Twenty-five firms with "less complex" operations in the U.S. will be permitted to file tailored plans as outlined in the Final Rule.
- Sixty-one firms with "limited" operations in the U.S. will be permitted to focus on material changes to their initial plan and actions to strengthen their resolvability under that plan.

Commentary

Despite the Agencies' acknowledgement that it is difficult for the eleven very large entities to prepare plans that are "credible" and facilitate an orderly resolution under the U.S. Bankruptcy Code, they have nevertheless agreed that these firms must be "responsive" to the identified shortcomings and take "meaningful action to improve their resolvability" in their 2015 submissions. Failure to do so could result in regulatory action, as outlined in Section 165(d) of the Dodd-Frank Act.

Based on the released statements, the FDIC Board is likely to take a particularly hard line with respect to its review and assessment of these 2015 plans. FDIC Vice Chairman Hoenig stated, "There is every reason to expect a credible plan from these firms." FDIC Board Member Jeremiah Norton stated that the Agencies have agreed to issue new instructions for the First-Wave Filers in advance of their July 1, 2015, submissions and added that these instructions will address issues "such as legal structure, financial contracts with early termination rights, shared services, and operational capabilities." The July 2014 submissions recently made by the First-Wave Filers were not mentioned.

The extent to which the First-Wave Filers' "shortcomings" vary will be highlighted in the individual letters the Agencies sent to the firms, which should be carefully reviewed and addressed. The task will likely be daunting, particularly in areas where the identified issues lie outside of the firms' direct control. Notwithstanding such concerns, firms would do well to show consideration of all items identified and to address those issues within their control, such as enhancing their ability to:

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- Produce reliable information in a timely manner;
- Report information on a legal entity basis;
- Assess the impact of outsourced activities on critical operations and core business lines at the time of resolution;
- Establish communication protocols with all of the necessary authorities;
- Incorporate a "war-games"-type analysis into the resolution analysis; and
- Assess and evaluate the impact of "bail-in" type debt to improve resolvability.

The Agencies' statement on the resolution plans for Covered Companies with less than $100 billion in non-bank assets highlights certain areas of concern for those thirty-one firms in this category identified as having "more complex" operations, including global issues, FMU interconnections, and funding and liquidity. This is particularly concerning as these firms are far less complex than the eleven First-Wave Filers, and is perhaps another indication of the hard line stance the FDIC appears to be taking with respect to the resolution planning process, even for firms with less than $100 billion in non-bank assets. As such, these thirty-one firms should be aware of the areas of concern highlighted in the Agencies' statements regarding the First-Wave Filers' second round shortcomings as they prepare their own second round plans.

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