ReedSmith

Living With 'Living Wills'

Author: Michael E. Bleier, Partner, Pittsburgh
Author: Mark F. Oesterle, Counsel, Washington, D.C

Publication Date: April 14, 2011

The Dodd-Frank Act (the "Act") contains several provisions creating significant compliance challenges for covered financial institutions. Some of the measures will impose novel responsibilities. Some may change the way firms plan and conduct business, causing them to divest or discontinue business activities, restructure, or forego new acquisitions or activities altogether. Some will require firms to gather, store, analyze and understand massive amounts of data. One provision, however, Section 165(d), has the potential to do all of these things. Covered firms (which are bank holding companies with total consolidated assets of $50 billion or more, and nonbank financial companies designated as systemically important by the Financial Stability Oversight Council and placed under the supervision of the Federal Reserve Board, collectively called "SIFIs") need to begin to consider the implications of this significant provision.

Section 165(d) requires SIFIs to produce a plan that details how the company could be resolved in a rapid and orderly fashion in the event of material financial distress or failure. These resolution plans have come to be known as "living wills." The concept of living wills for financial institutions first gained favor in Great Britain in the aftermath of the 2008 financial crisis. The idea is that requiring firms to develop such plans in advance, forces them to review their operations, obligations, activities and exposures, and estimate how to minimize the market disruption that might result from their financial demise. This effort is intended to produce two results: First, firms finding impediments to an orderly resolution would have to change the structure, cease the activity or liquidate the exposure causing the problem; and second, upon completion of the plan, the firms would have an outline that could be followed in the event of severe financial distress.

The Act requires the Federal Deposit Insurance Corporation ("FDIC") and the Board of Governors of the Federal Reserve System ("the Fed") (collectively the "regulators"), to issue

joint regulations to implement Section 165(d) by January 21, 2012. On April 12, 2011, the Board and the FDIC published a joint proposed rule regarding living wills and credit exposure reports. The public comment period is open until June 10, 2011.

The FDIC proposal requires a SIFI to prepare and submit a living will and a quarterly report of its credit exposure to other SIFIs, and their exposure to the covered SIFI firm. The proposal also establishes the rules and requirements regarding the submission and the content of the living wills and reports. Each living will must contain a plan for the SIFI's rapid and orderly resolution. As part of the plan, the firm must provide a strategic analysis as to how it would be resolved without harming the stability of the financial system. The plan must also detail the firm's structure, management, and operations (including both foreign and domestic activities), and provide information about its counterparty and credit exposures, funding, liquidity and capital resources, and its strategy for maintaining its critical operations and business lines in an environment of material financial distress.

The proposed rule would make reporting an ongoing responsibility. Initially, covered companies must file resolution plans within 180 days of the effective date of the final rule. Thereafter, there would be an annual requirement to provide an up-to-date plan 90 days after the end of each calendar year. Any change in a SIFI's business operations that would have a material effect on the current resolution plan, such as a significant acquisition or sale, discontinuation of a material or core business line, loss of a material servicing contract, major commitment to a new line of business, or revocation of a material license or other regulatory authorization, would trigger the responsibility to furnish a new plan within 45 days. The Fed and the FDIC have made clear their intent to treat the plans as organic documents that must closely reflect changes in SIFIs' structures and activities. To this point, FDIC Chairman Sheila Bair stated, "The FDIC and the Fed wield considerable authority to shape the content of these plans, first in this rulemaking and second through the ongoing monitoring of the institutions' compliance."

The Fed and the FDIC are given the authority to review the plans and to take remedial action if they find a plan to be deficient. They can reject a plan and require that it be revised and resubmitted. If a SIFI fails to act or fails to correct the deficiencies in its plan, the regulators can impose stricter capital, leverage or liquidity requirements, and can even impose restrictions on

the entity's growth activities or operations. If a firm takes no action to revise its plan and address any noted deficiencies, the regulators can force it to divest such assets or operations as the Fed and the FDIC deem necessary for an orderly resolution under the Bankruptcy Code. The purpose of the plans is twofold. First, as Chairman Bair indicated, they will "clearly lay out the structure and activity of the organization...as well as its exposures" to increase the likelihood, if necessary, of an orderly resolution. Secondly, by establishing the framework for a routine Title 11 bankruptcy proceeding, the plans will decrease the likelihood that a covered firm would have to be resolved using the Dodd-Frank Title II resolution regime, which was intended to be used only under extraordinary circumstances.

In light of the proposed "living will" rule, some of the issues or concerns that need to be considered by a covered firm are the following:

Supervisory Perspective: The statutory living will requirement increases the importance of risk management and contingency planning as factors in prudential regulation. It reverses the focus of the exercise, however, from how the SIFI will respond to external events that may disrupt or endanger its business, to how the SIFI can minimize the disruption it might cause in the financial markets. Although Section 165(d)(6) states that "a resolution plan...shall not be binding on a bankruptcy court, a receiver appointed under title II, or any other authority that is authorized to resolve (a covered institution) or any of (its) subsidiar(ies)," it will force SIFIs into the habit of reviewing and understanding their exposures and being prepared with well-thought-out action plans for when those exposures come under stress, although this may prove to be an academic exercise. The closest regulatory parallel can be found in the recent stress tests conducted by the Fed on the largest institutions (see March 18, 2011, Comprehensive Capital Analysis and Review: Objectives and Overview). The key difference in the regulatory approach can be summed up by the new kind of question regulators will be asking covered firms: Where once they made firms answer the question "what are you doing?" they will soon also require a response to the question "what will you do if...?"

Planning Criteria: Another key issue raised by the resolution plan requirement is the criteria by which the regulators will judge the adequacy of the plans. The statute directs the regulators to determine whether a firm's living will demonstrates that the entity could be resolved under the

Bankruptcy Code in a way that would not pose systemic risks to the financial system. Neither the FDIC nor the Fed has significant experience with the Bankruptcy Code. The FDIC resolves depository institutions pursuant to the FDIC Act, and the Fed plays only a limited role in certain bankruptcy proceedings. Until the regulators significantly increase their core competency with respect to the Bankruptcy Code, it may be advisable for SIFIs to include in their plan explanations of why certain elements are necessary to "facilitate an orderly resolution...under title 11."

Distressed Circumstances: Beyond the question of the application of the law remains the broader and more complicated matter of the assumptions a covered firm must make with regard to the factual circumstances surrounding its living will. While many aspects of a firm's structure and operations are determinable, the overall economic and financial circumstances in which its hypothetical failure will occur are not. Without knowing what caused the distress leading to the "failure," it will be difficult for a firm to establish that its resolution plan will actually prevent further distress. Unfortunately, the statute does not address this matter. The FDIC proposal allows firms to "take into consideration that the event of the material financial distress may be idiosyncratic or may occur at a time when financial markets...are also under stress," but this may not provide enough guidance. It may be necessary for the Fed and the FDIC to stipulate a range of circumstances covered firms must consider when developing their plans. Without greater clarity in the rule, plans may be based on too many assumptions for them to be meaningful.

Data Management: Developing and implementing a "living will" will require more extensive and granular information than commonly maintained in most financial and value at-risk systems. For example, a SIFI will need to know the terms, as well as the amount of its exposures to other SIFIs and market participants, in order to determine how they could be resolved in a bankruptcy proceeding. Any "living will" is therefore likely to require a significant expansion of legacy data systems and an array of new inputs.

Due Diligence Review: The need for more extensive operational data will also carry over to potential acquisitions, as a SIFI will need to conduct additional due diligence with respect to the target's business and operations in order to assess the potential impact of the acquisition on its "living will." At the same time, the acquiree or seller likely will need to clearly understand how its

business will be conducted going forward, including under circumstances of deep distress, and whether the benefits of the transaction will be realized.

Strategic Planning: The fact that SIFIs will be required to amend their plans 45 days after material events will have an impact on strategic planning. Firms will have to think about what their amended resolution plan will look like prior to proceeding with an acquisition, starting a new business line, or engaging with a new partner or counterparty. Because of the potential that regulatory uncertainty might spark market uncertainty, covered firms would be prudent to obtain some form of prior approval for their post-transaction resolution plans. While it is unclear whether the Fed and FDIC will choose to make resolution plan pre-approval something akin to the Hart-Scott-Rodino antitrust review, it is certain that Section 165's resolution plan requirements will add to the list of regulatory issues that must be considered prior to closing a deal.

Impact on Acquisitions: The requirement for a "living will" complicates the acquisition courtship process, and the effort to "sell a deal" or to acquire a new business line or activity. Quite likely, while the CEO is on Bloomberg or CNBC touting the transaction and its value, importance and growth potential, the firm will have to be simultaneously preparing its plan to dispose of the asset or business line. How the market will react to such contradictory messages is unclear. It also remains to be seen what types of disclosures will be required under the securities laws.

Confidential Treatment: Another concern the living-will proposal raises is the need for ensuring that the resolution plans that are developed by the SIFIs and any required modifications are accorded confidential treatment throughout the process. That also includes the fact that a resolution plan was deemed not credible or deficient. Disclosure of such fact would likely be viewed by the marketplace as almost a denial of the transaction, even though the concern might be easily resolved. Again, how this process is treated for securities law purposes will be significant.

Other Questions: There are also other numerous and unanswered questions with respect to resolution plans: Can shareholders review them? Will creditors and counterparties be able to access them and, if so, will they be allowed to amend them? How will creditors and

counterparties react to the treatment they are provided under the plans? Will the regulators discuss the contents of the plans with foreign regulators?

While the intent of the living will makes logical sense, its implementation has many unforeseen consequences that will significantly complicate the regulatory framework for covered firms. Implementation will be even more difficult for the nonbank SIFI that is for the first time coming under a prudential supervisory regime. While it is hoped that the living will never gets probated, its development is one of the most difficult regulatory burdens imposed not just on the systemically important financial organizations, but also on the involved regulatory authorities: The Fed, the FDIC and the Financial Stability Oversight Council.

About Reed Smith

Reed Smith is a global relationship law firm with more than 1,600 lawyers in 23 offices throughout the United States, Europe, Asia and the Middle East.

The information contained herein is intended to be a general guide only and not to be comprehensive, nor to provide legal advice. You should not rely on the information contained herein as if it were legal or other professional advice.

The business carried on from offices in the United States and Germany is carried on by Reed Smith LLP of Delaware, USA; from the other offices is carried on by Reed Smith LLP of England; but in Hong Kong, the business is carried on by Reed Smith Richards Butler. A list of all Partners and employed attorneys as well as their court admissions can be inspected at the website **http://www.reedsmith.com/**.

© Reed Smith LLP 2011. All rights reserved.