Living Wills: Early-stage Planning

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Every systemically important financial institution ("SIFI")[1] should now begin its early-stage planning for the preparation of a resolution plan, or living will (the "Plan"). The Plan, required by section 165(d) of the Dodd-Frank Act,[2] is a detailed contingency plan that describes how a SIFI that is at risk of default can be sold, broken up, or wound down quickly and effectively in a way that mitigates serious adverse effects to U.S. financial stability.

The Plan is, metaphorically speaking, one of the joints in the systemic risk regulatory framework at which three supports meet.

- ***Management of external consequences.*** The Plan will explain how the core functions of a SIFI would continue and how its counterparties could continue their business if the SIFI were to fail.[3] In this respect, the Plan is concerned solely with the external consequences of failure and is not itself designed to prevent the failure of a SIFI. (Dodd-Frank contains several other provisions for this purpose.)
- ***Critical information source.*** Given the required content, the Plan will be a new source of critical information for ongoing supervision by the Federal Reserve Board ("FRB"). Indeed, on the basis of the Plan and their understanding of the financial system, the FRB and the Federal Deposit Insurance Corporation ("FDIC") can force changes in operations allowing a SIFI to survive, including jettisoning certain business lines, and forcing restructurings.
- ***Roadmap.*** The Plan will serve as a detailed roadmap for a rapid and orderly liquidation of a SIFI under Title II of Dodd-Frank.

Accordingly, the Plan should include discussions both of the continuity of core functions and minimization of the exposure of counterparties in a liquidation, as well as strategies for recovery and resolution.

I. Early-stage Planning

A SIFI will have 180 days after the FRB and the FDIC (collectively, the "Agencies") publish a final rule in which to submit a Plan acceptable to the Agencies.[4] This time horizon is

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[1] We use "SIFI" as a shorthand term for three separate classes of institutions covered by the systemic risk provisions of Dodd-Frank: U.S. bank holding companies with more than $50 billion in consolidated assets, foreign banking organizations that are or are treated as bank holding companies and that also have more than $50 billion in consolidated assets (wherever located), and nonbank financial institutions that are deemed systemically important by the Financial Stability Oversight Council.

[2] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (July 21, 2010) (the "Dodd-Frank Act" or "Dodd-Frank").

[3] Enabling the regulators to understand how to manage counterparty relationships in the event of failure is one function of the credit exposure report, a requirement in Dodd-Frank closely related to the Plan. We discuss the credit exposure report below.

[4] Dodd-Frank requires that the Agencies finalize a rule by January 21, 2012. In April 2011, the Agencies proposed a rule (the "Proposed Rule"), 76 Fed. Reg. 22648 (April 22, 2011). The FDIC states on its website that a final rule will be issued before the end of 2011. The FRB has been silent regarding the timeline. At least one recent news story reports that another issuance is likely in September, although the substance of it is unclear. *See* "U.S. Living-Wills Rule May Stop Short on Key Issues, Person Says,"

aggressive, particularly in light of the likely scope and required detail of the Plan. Generally, a successful Plan will depend on four ongoing tasks that are time-consuming and resource-intensive:

1. ***Involving all stakeholders.*** The scope and detail of the Plan will require the participation of virtually all of senior management from both material operating units and critical corporate and support functions. Ultimately, the board of directors must approve the plan. One of the first tasks, then, is to create a robust framework for communications, responsibility, and accountability. Early action is important in order to leave sufficient time for review of the Plan by senior management and the board.
2. ***Explaining the business and collecting data.*** The development of recovery and resolution options and the presentation to the Agencies will require a comprehensive and granular understanding of the entire organization: material operating units, specific exposures to particular internal and external risks (including counterparty credit exposures and cross-guarantees), and critical functions that must be continued in resolution. Accordingly, a SIFI should begin now to identify the specific types of information it will need from each business unit.
3. ***Integrating the work with other Dodd-Frank requirements.*** The Plan is just one of a series of tools that Dodd-Frank created for the regulation of systemic risk. Dodd-Frank explicitly ties the Plan to credit exposure reports and stress testing. The substance of the Plan will overlap with several other requirements as well. Some obligations will come into play before the Plan must be completed, such as stress tests and capital plans, and others afterwards. Coordination of the various compliance obligations is essential and should be arranged at the outset.
4. ***Developing the credit exposure report.*** Nearly inseparable from a Plan is a SIFI's credit exposure report, which will be used, among other purposes, to test the Plan. Given the complexity of the report and its key relationship to the Plan, each SIFI should assess the resources and information necessary to develop the report and assign responsibility for its creation.

II. Strategic Components of a Plan

A plan must explain how a SIFI may be resolved in a "rapid and orderly fashion" if it defaults. "Rapid and orderly resolution" is (according to the Proposed Rule) "a reorganization or liquidation of the Covered Company . . . under the Bankruptcy Code that can be accomplished within a reasonable period of time and in a manner that substantially mitigates the risk that the failure of the Covered Company would have serious adverse effects on financial stability in the United States."[5]

Therefore, a Plan will require at least two strategic components: (1) a recovery plan/going concern/reorganization analysis and (2) a resolution/potential liquidation analysis.

Bloomberg (Aug. 29, 2011), http://www.bloomberg.com/news/2011-08-29/u-s-living-wills-rule-may-stop-short-on-key-issues-person-says.html

[5] 76 Fed. Reg. at 22649.

Plan Elements

Under the Proposed Rule, each Plan would include seven parts: (i) an executive summary, (ii) a strategic analysis, (iii) a description of the corporate governance structure for resolution planning, (iv) a description of the overall organizational structure, (v) a description of management information systems, (vi) a description of interconnections and interdependencies, and (vii) an identification of supervisory authorities and regulators. The details of each part are as follows:

1. **Executive summary.** The first part summarizes the key elements of a strategic plan. After the initial submission, the summary should address any material changes from the most recent filing, and any actions taken by a SIFI to improve the effectiveness of the Plan or address any material weaknesses of the Plan.
2. **Strategic analysis.** This analysis includes a plan to utilize resources (e.g., funding, liquidity, and capital) in order to facilitate an orderly resolution of "material entities," "core business lines," and "critical operations." "Core business lines" encompass any operating business or support function that, in a SIFI's view, would result in a material loss of revenue, profit, or franchise value in the event of the SIFI's failure "Critical operations" covers those operational businesses or support functions that, upon a failure of such business or support function, would likely result in a disruption to the U.S. economy or financial markets. A "material entity" is a foreign office or a subsidiary that is significant to the activities of a critical operation or core business line.

   A strategic analysis requires a SIFI to:

   - ***Identify*** assumptions relating to the resolution process and the economic or financial conditions that would be present at resolution;
   - ***Map*** funding, liquidity, support functions, and other resources, including capital, to the SIFI's material entities, core business lines, and critical operations;
   - ***Explain*** how these resources will be utilized to facilitate an orderly resolution;
   - ***Describe and analyze*** the range of specific actions required to facilitate a SIFI's rapid and orderly resolution, with respect to its material entities, critical operations, and core business lines;
   - ***Provide*** strategies in the event of a failure or discontinuation of a material entity, core business line, or critical operation, and the actions that the SIFI would take to prevent or mitigate any adverse effects of such failure or discontinuation on the financial stability of the institution and the United States;
   - ***Ensure*** that any insured depository institution subsidiary would be adequately protected from risks arising out of nonbank affiliates, e.g., demonstrating that relationships with the affiliates have not created credit or liquidity risk for the insured depository institution;[6] and

[6] This part of the Resolution Plan would also involve a public relations strategy to reduce reputational and liquidity risk that would be increased by the failure of a nonbank affiliate.

- ***Demonstrate*** how core business lines and critical operations could be resolved, and how the SIFI's businesses could be transferred to potential acquirers.

3. **Description of corporate governance structure for resolution planning.** This portion of the plan describes the integration of resolution planning into the SIFI's corporate governance structure and identifies the senior management officials primarily responsible for overseeing compliance with the rule. The largest SIFIs may find it necessary to create a central planning function that reports to the chief risk officer or chief executive officer and makes periodic reports to the board of directors. A SIFI should consider adopting procedures similar to those in place for Sarbanes-Oxley disclosure and internal controls compliance.[7]

4. **Description of overall organization structure.** This organizational description includes (a) a hierarchical list of all material entities, as well as jurisdictional and ownership information and a mapping to core business lines and critical operations; (b) an unconsolidated balance sheet and a consolidating schedule for all entities that are subject to consolidation; (c) information regarding material assets, liabilities, derivatives, hedges, capital and funding sources, and major counterparties; (d) an analysis of the potential effects of the bankruptcy of a major counterparty; and (e) material trading, payment, clearing, and settlement systems utilized by a SIFI. Foreign operations also would have to be described in considerable detail.

5. **Description of management information systems.** This section describes the management information systems that support a SIFI's core business lines and critical operations. This part of the plan would include information on legal ownership, intellectual property rights, and a plan for continued availability of systems that support core business lines and critical operations. The description of management information systems should include both static (e.g., description of business lines, supervisory information) and dynamic data (e.g., exposures to counterparties, funding and liquidity, available lines of credit, etc.).

6. **Description of interconnections and interdependencies.** This description identifies interconnections and interdependencies (a) among a SIFI and its material entities and affiliates, and (b) among the SIFI's critical operations and core business lines. This section also describes how the SIFI would ensure continued availability and sustained service levels during material financial distress or insolvency.

7. **Identification of supervisory authorities and regulators.** Finally, the Plan identifies all of a SIFI's supervisory authorities and regulators. This section also describes a plan to continue processes and systems to collect, maintain, and report the information and other data underlying the Plan.

[7] For more information on how a SIFI can use existing Sarbanes-Oxley methodology for implementing the Living Wills requirement, *see* http://www.mofo.com/files/Uploads/Images/110614-Using-Existing-Sarbanes-Oxley-Methodology-to-Implement-Living-Wills-Requirement.pdf.

III. Foreign SIFIs

A description of operations outside the U.S. presumably would be included in most parts of a Plan.[8] The preamble to the Proposed Rule states that a foreign-based SIFI would be required to provide (i) information regarding its U.S. operations, (ii) an explanation of how resolution planning would be integrated with the SIFI's overall contingency planning process; and (iii) information regarding the interconnectedness and interdependencies among U.S. operations and foreign operations.

Dodd-Frank also requires that, in applying the resolution plan and credit exposure report requirements to a foreign-based SIFI, the FRB and the FDIC "give due regard to the principle of national treatment and equality of competitive opportunity" and take into account the regulatory standards for consolidated supervision by the home-country regulator. A possible mechanism to satisfy this "due regard" requirement is the Credit Management Group ("CMG") that the Financial Stability Board ("FSB") has discussed. Each SIFI would have its own CMG, which would consist of representatives of all of the jurisdictions in which the SIFI had operations and would be led by the home-country supervisor. Institution-specific cross-border agreements would be necessary.[9]

IV. Procedural requirements

The Proposed Rule requires that a SIFI submit a Plan within 180 days of the effective date of a final rule, or within 180 days after the company passes the $50 billion threshold for bank holding companies or is deemed systemically important, and annually thereafter. A SIFI will also be required to file an updated plan within 45 days after any "material change," a term broadly defined in the Proposed Rule to include and changes in circumstances that reasonably could have a material effect on a Plan.

A SIFI's board of directors would be required to approve the initial and each subsequent annual Plan. A delegee of the board of directors may approve updates in connection with a material change.

V. Review and approval process

The Proposed Rule sets forth a formal review process, although we would expect that in practice there would be substantial back-and-forth between a SIFI and the Agencies before a Plan is submitted:

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[8] Note that news reports indicate that a consensus on the cross-border elements of resolution planning have yet to emerge. The *Bloomberg* story, n. 3, *supra*, reports that the FRB and FDIC may release a second proposal in September that does not discuss the sharing of information with foreign regulators nor the winding-down of the foreign operations of U.S. SIFIs. *The Financial Times* separately quotes an FDIC official on the importance of cross-border resolution planning. *See* "Resistance to living wills could prove futile," Fin. Times (Aug. 22, 2011), http://www.ft.com/intl/cms/s/0/fae28e00-ccc6-11e0-b923-00144feabdc0.html?ftcamp=rss#axzz1WiDhW7BE.

[9] FSB, Consultative Document: Effective Resolution of Systemically Important Financial Institutions, Annex 3 (July 19, 2011). The members of the FSB are the central banks, finance ministries, and certain financial regulators of 24 countries, including the U.S. We described this FSB document in a recent client alert. *See* http://www.mofo.com/files/Uploads/Images/110217-European-Resolution-Recovery-Framework.pdf.

1. The Agencies first determine whether the Plan appears "informationally complete," in which case it is accepted for further review. If the Plan is "informationally incomplete," the Agencies would require that a SIFI resubmit an informationally complete plan within 30 days.

2. After accepting a plan for further review, the Agencies would determine whether the plan is "credible" and whether it would facilitate an orderly resolution. There is no provision for a formal approval. If a Plan fails either criterion, the Agencies would then notify the SIFI in writing, specifically identifying the deficiencies. Generally, within 90 days of receiving a notice of deficiencies, the SIFI would be required to submit a revised Plan that presumably would include changes to business operations and corporate structure.

3. If the SIFI fails to submit an acceptable revised Plan, the Agencies may jointly subject the Covered Company or any of its subsidiaries to more stringent capital, leverage, or liquidity requirements, or restrictions on growth, activities, or operations. If within two years of the imposition of the more stringent requirements the SIFI fails to submit a credible revised plan and if the Agencies previously had imposed more stringent requirements, then the Agencies may issue an order directing a SIFI to divest certain assets or operations. The order will be based on a determination by the Agencies that a divestiture is necessary in order to facilitate an orderly resolution.

The "credibility" of a Plan is not defined in section 165(d) or discussed in the Proposed Rule. Some insight may be available from international sources on resolution planning. In a recent proposal, the FSB explained (in something of a double negative) that "for resolution to be credible, the application of those resolution tools would not itself give rise to unacceptably adverse broader consequences for the financial system and the real economy."[10] In short, credibility is measured by the likely market reaction to a resolution proposed in a Plan and whether counterparties and others would continue normal operations, confident that the resolution would be orderly. Such a subjective standard likely would be difficult for the FRB and FDIC (or any regulator) to apply when reviewing a Plan.

VI. Confidentiality

Implicit in the Proposed Rule are two confidentiality risks. The Plan requires a SIFI to provide detailed information of the most sensitive nature about its core businesses, critical operations, trading books, and counterparty exposures. First, protection of the information is not automatic or absolute. The SIFI submitting a Plan must request confidential treatment under the Freedom of Information Act and the regulations of the Financial Stability Oversight Council ("FSOC"), FRB, and FDIC dealing with nonpublic information. The protection offered under all of these regimes is conditional. A Plan should be entitled to the same protection as examination-related materials, but the Proposed Rule does not clarify or confirm this point. Confidentiality may also be affected by other provisions of Dodd-Frank that require public disclosure. Stress test results under section 165(i) must be made public; these results could allow for some reverse engineering into a Plan.

[10] *See* FSB, Consultative Document, supra n. 9, Annex 4, at 47. The Financial Services Authority ("FSA") in the UK has adopted the FSB definition in its own proposal, Consultative Paper CP 11/16: Recovery and Resolution Plans (Aug. 2011). We have discussed the FSA consultative paper in a recent client alert, http://www.mofo.com/files/Uploads/Images/110819-FSA-Recovery-Resolution.pdf.

Second, there are securities law disclosure requirements that might come into play at some point. At an FDIC Board meeting held on July 6, 2011, the FDIC Board discussed whether a decision that a plan was not "credible" would require the institution involved to disclose that fact in an 8-K. If the past is any guide, the FDIC Board will not attempt to resolve this issue and will leave each institution to interpret securities law requirements on its own.

VII. Credit exposure reports

The Proposed Rule provides less detail on Credit Exposure Reports, but that should not minimize their importance. The lack of detail may, in part, be due to some of the other pending Dodd-Frank initiatives described above, including stress testing and capital planning. In any event, the Credit Exposure Reports would present a major test for the adequacy of a Plan and the Plan should be developed so as to take account of the elements of the Credit Exposure Report.

Contents

Under the Proposed Rule, a SIFI is required to submit a quarterly Credit Exposure Report that sets forth the nature and extent of its credit exposure to each significant institution, as defined by the Board,[11] and the nature and extent of each of those company's credit exposures to a SIFI. The Proposed Rule would require a SIFI to report exposures associated with:

1. Extensions of credit, including loans, leases, and funded lines of credit, as well as intra-day credit;

2. Committed but undrawn lines of credit;

3. Deposits and money placements;

4. Repurchase agreements, reverse repurchase agreements, securities borrowing transactions, and securities lending transactions (each, on a gross and net basis);

5. Guarantees, acceptances, or letters of credit (including endorsement or standby letters of credit);

6. Purchases of or investments in securities issued by significant institutions;

7. All counterparty credit exposures (on a gross and net basis) in connection with derivative transactions; and

8. Any other transactions that result in credit exposures that the Federal Reserve determines to be appropriate.

[11] Under a proposed rule by the FRB, a "significant nonbank financial company" would be any nonbank financial company that has $50 billion or more in consolidated assets or has been deemed systemically important by the FSOC. The term "significant bank holding company" would include the bank holding companies subject to enhanced prudential standards: U.S. bank holding companies and foreign banking organizations treated as bank holding companies with $50 billion or more in consolidated assets. *See* 76 Fed. Reg. 7731 (February 11, 2011). The FRB expects to issue a final rule by the end of September 2011.

The Proposed Rule would also require a description of the systems and processes that a SIFI uses to (a) collect and aggregate the data underlying the Credit Exposure Report and (b) produce and file the Credit Exposure Report. Given the breadth of information that the Agencies could request under the Proposed Rule, it is clear that the Credit Exposure Reports are intended to cover as broad a spectrum of exposure types as possible, including hard exposures (e.g., loans and leases) and soft exposures (e.g., intra-day, etc.), as well as funded and unfunded exposures, and committed and uncommitted lines of credit.

Timing.

A SIFI would be required to submit a Credit Exposure Report quarterly; however, the Proposed Rule does not provide a deadline for the initial report. Board of directors' approval would not be separately required for Credit Exposure Reports.

Confidentiality

The Proposed Rule would require a SIFI to specifically request confidential treatment of the Credit Exposure Reports that it submits; however, the Proposed Rule does not address the treatment of these reports under the Freedom of Information Act or the consequences for an inadvertent government disclosure. Based on comments from Agency officials, we expect that the final rule will address these issues.

VIII. Regulatory landscape

A Plan is a dynamic document, and its contents will influence and be influenced by actions taken to comply with other Dodd-Frank requirements. A Plan cannot be drafted or implemented solely by reference to section 165(d). Instead, SIFIs will need to adopt a comprehensive approach, incorporating (or at least synchronizing with) related initiatives and requirements.

The FRB has said that by the end of September 2011, it will have issued a proposed rule addressing many of the new Dodd-Frank requirements.[12] In developing a Plan, a SIFI should keep in mind the following:

- ***Counterparty credit exposure limits.*** The FRB must issue regulations to limit credit exposures to third parties. The regulations must include a ceiling on exposures to any one counterparty of 25 percent of total capital. The limits would not take effect until July 21, 2013, and the FRB may extend the deadline to July 21, 2015. SIFIs should be aware as well of interagency guidance on counterparty credit risk management that the FRB, FDIC, and Office of the Comptroller of the Currency issued on June 29, 2011.[13] This guidance covers all U.S. bank holding companies and banks (not just SIFIs), but does not cover nonbank SIFIs. Ideally, this guidance should be read together with the proposed rule on credit exposure limits. The continuity of counterparty relationships is a key element of a Plan, and limits on counterparty exposures will inform the steps necessary in a resolution to support such continuity.

[12] The proposed rule is expected to cover all of the following requirements, except for a proposal on resolution planning at the bank level and Title II.
[13] *See* Interagency Counterparty Credit Risk Management Guidance, S&R Letter 11-10 (July 5, 2011).

- ***Stress testing.*** Nearly all SIFIs have been engaged in stress testing for some time. Section 165(i) of Dodd-Frank formally requires the FRB to conduct annual stress tests of all SIFIs, and SIFIs must conduct their own tests on a semiannual basis.[14] In June 2011, the FRB (together with Treasury, the FDIC, and the Office of the Comptroller of the Currency) proposed stress test guidance that would inform the section 165(i) rule.[15] The nature and results of the stress tests are vital to a Plan because the FRB may require revisions to a Plan based on stress test results.

- ***Early remediation regime.*** Section 166 of Dodd-Frank requires the FRB (in consultation with the FSOC and FDIC) to establish a series of specific remedial actions—i.e., more stringent prudential standards—as a SIFI experiences increasing financial distress. (The model for this regime is the prompt corrective action framework for insured depository institutions.) A Plan will have to take account of any new limitations that will have taken effect before a resolution strategy is implemented.

- ***Capital requirements.*** Several provisions in Dodd-Frank address capital requirements for SIFIs. In June 2011, the FRB, FDIC, and OCC issued a final rule implementing a portion of the Collins Amendment (section 171 of Dodd-Frank) to establish a capital floor for U.S. bank holding companies that have adopted Basel II.[16] The proposed section 165 rule should address enhanced capital standards for SIFIs. Capital standards are an important starting point for assessing the impact of adverse events and whether they would trigger resolution.

- ***Capital plans.*** In a release in June 2011, technically separate from Dodd-Frank, the FRB proposed an annual capital plan requirement for U.S. bank holding companies with consolidated assets of $50 billion or more.[17] The annual capital plan would be a companion piece to the Plan, since it would explain how a company would maintain its financial condition "under stressful conditions." The proposed rule builds on several programs undertaken by the FRB (and other agencies) in response to the financial crisis.

- ***Resolution plans of insured depository institutions.*** In May 2010, before the enactment of Dodd-Frank, the FDIC issued a proposed rule (popularly known as the "IDI Rule") that would impose resolution planning obligations on insured depository institutions with more than $10 billion in total assets that are owned or controlled by parent companies with more than $100 billion in total assets.[18] This rule, if finalized, would apply to the bank subsidiaries of many SIFIs (and not to banks of any non-SIFIs). The FDIC has said it will "synch up" the two resolution planning requirements.

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[14] *See* 12 U.S.C. § 5365(i).
[15] *See* 76 Fed. Reg. 35072 (June 15, 2011).
[16] *See* 76 Fed. Reg. 37620 (June 28, 2011). Note that all of the U.S. bank holding companies that have adopted Basel II are also SIFIs.
[17] *See* 76 Fed. Reg. 35351 (June 17, 2011).
[18] *See* 75 Fed. Reg. 27464 (May 17, 2010).

- ***The Orderly Liquidation Authority.*** This authority,[19] which will be exercised by the FDIC in specific cases, will play a role in the FDIC's review of a Plan.

IX. Conclusion

Development of a Plan will be a substantial undertaking. Because of the accelerated timeframe in which a Plan must be produced, each SIFI should begin the first steps in the process now. The SIFI should assemble a team whose first tasks involve:

- Establishing clear lines of responsibility and ensuring that all stakeholders in the process are involved, including senior management of all material business units.
- Determining the types of information necessary for the Plan and the business units that will provide it.
- Coordinating with others at the institution responsible for compliance with other Dodd-Frank requirements.
- Assigning responsibility and understanding the requirements of the credit exposure report.

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[19] For more on the framework of the Orderly Liquidation Authority framework, *see* our Client Alert: http://www.mofo.com/files/Uploads/Images/ 100831TitleII.pdf.