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August 19, 2011

SIFI Resolutions and Living Wills: The Financial Stability Board Proposal (and some U.S. and UK observations)

On July 19, 2011, as part of a broad program to enhance the regulation of systemically important financial institutions ("SIFIs"), the Financial Stability Board ("FSB") published a consultative document, "Effective Resolution of Systemically Important Financial Institutions" (the "FSB Paper").¹ The paper proposes several additions to and improvements in domestic and cross-border resolution regimes, including the preparation of Recovery and Resolution Plans ("RRPs"). Comments are due by September 2, 2011.

The proposals in the FSB Paper are not unexpected, and many have been telegraphed over the past several months at least. The release of the paper and the FSB's plan to make final recommendations to the G-20 in November will, however, cause the large majority of SIFIs to focus on these proposals.

In addition, nearly all SIFIs will need to assess the impact of the proposals in the FSB Paper in the light of other proposals in the United States, the European Union and the United Kingdom.² Today we are publishing another client alert that discusses the UK Paper in detail.³ The proposals share the same underlying policies, but there are differences that present the possibility of divergence in resolution policy, particularly in early stage planning. Actual or potential differences that exist include such issues as the universe of SIFIs covered, the scope of resolution plans, the nature of a "resolvability" assessment, "bail-in" power, the treatment of branch offices or subsidiaries of SIFIs based elsewhere, and the treatment of custodial functions.

BACKGROUND

The FSB Paper is a companion piece to another FSB Paper (the "BCBS Paper") published the same day by the Basel Committee on Banking Supervision ("BCBS").⁴ The BCBS Paper describes a scoring system for determining systemic importance of global banking organizations and a set of capital surcharges for those that are systemically important. We

¹ "Effective Resolution of Systemically Important Financial Institutions," http://www.financialstabilityboard.org/publications/r_110719.pdf. The FSB Paper can be traced, in part, to a March 2010 BCBS Paper, "Report and Recommendations of the Cross-border Bank Resolution Group," <http://www.bis.org/publ/bcbs169.pdf>. In July, the BCBS published a separate follow-up to that document, "Resolution policies and frameworks – progress so far," <http://www.bis.org/press/p110706.htm>

² Part of the US resolution regime already has been established by the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), Pub. L. No. 111-203, 124 Stat. 1376 (July 21, 2010). Additionally, a proposed rule on resolution plans and associated credit exposure reports (the "US Proposal") currently is pending in the US. See 76 Fed. Reg. 22648 (Apr. 22, 2011), <http://edocket.access.gpo.gov/2011/pdf/2011-9357.pdf>. The Financial Services Authority in the UK ("FSA") published earlier this week a consultative document, "Recovery and Resolution Plans," CP11/16 (Aug. 2011) (the "UK Paper"), http://www.fsa.gov.uk/pubs/cp/cp11_16.pdf.

³ "R&R' the Hard Way – the FSA's Consultation on Recovery and Resolution," <http://www.mofo.com/files/Uploads/Images/110819-FSA-Recovery-Resolution.pdf>.

⁴ "Globally systemically important banks: Assessment methodology and the additional loss absorbency requirement," <http://www.bis.org/publ/bcbs201.pdf>. Note that this document is limited to banking organizations, while the FSB Paper covers all SIFIs. The deadline for comments on the BCBS Paper is August 26, 2011, one week earlier than the deadline for comments on the FSB Paper.

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discussed the BCBS Paper in a news bulletin last week.⁵ One tentative lesson to draw from the BCBS Paper is that the BCBS and the FSB contemplate a smaller universe of SIFIs than is provided for in Dodd-Frank or anticipated by at least some U.S. regulators.

The starting point for the FSB Paper and the BCBS Paper is the framework for SIFI regulation that the G-20 Leaders approved at their November 2010 meeting.⁶ The framework has four elements: (i) improvements in resolution regimes; (ii) additional loss absorption capacity by SIFIs; (iii) more intensive supervisory oversight of SIFIs; and (iv) robust core financial market infrastructure to reduce contagion risk from the failure of individual SIFIs. The FSB has described the FSB Paper and the BCBS Paper as the “bookends” to this framework. The FSB Paper addresses the first of the four elements and the BCBS Paper the second. The FSB and the BCBS have begun work on the others, although no proposals or studies have been released.⁷ The FSB intends to present a final set of recommendations on resolutions and loss absorption to the G-20 Leaders at their November meeting in Cannes.

THE FSB RESOLUTION FRAMEWORK

The FSB Paper is based on four building blocks, each of which is discussed in greater detail below:

- **Strengthened national resolution regimes.** A designated resolution authority should have a broad range of powers and tools to resolve a financial institution that is no longer viable and has no reasonable prospect of becoming so. Among other powers, the resolution authority should be able to “bail in” unsecured creditors.
- **Cross-border cooperation arrangements.** Countries should enter into bilateral or multilateral institution-specific cooperation agreements, underpinned by national law, that will enable resolution authorities to act collectively to resolve cross-border firms in an orderly way.
- **Improved resolution planning by firms and authorities.** The home-country resolution authority should conduct *ex ante* resolvability assessments of SIFIs. These assessments could lead to changes in national law and in individual firm structures and business practices. Each SIFI should prepare a Recovery and Resolution Plan (“RRP”). The resolvability assessment and the RRP are intertwined and likely would be completed at the same time. Additionally, each SIFI’s RRP will be reviewed by its home-country resolution authority and by the authorities in all of the SIFI’s host countries.
- **Measures to remove obstacles to resolution.** SIFIs should address issues that may hinder an orderly resolution, specifically including fragmented information systems, intra-group transactions, reliance on service providers and the provision of global payment services.

The FSB Paper also requests comment on two legal issues. First, the statutory priorities of creditor claims may vary among jurisdictions, particularly the issue of a separate preference for depositors. The differences could complicate a cross-border resolution. The FSB does not suggest a particular solution, although it is difficult to imagine any country, such as the U.S., adjusting its treatment of bank depositors to suit international needs. Second, early termination clauses that are a standard part of many financial contracts may enable counterparties to exit the transactions at the moment of

⁵ “Defining Global Systemically Important Banks and Additional Loss Absorbency Requirements” (Aug. 12, 2011), <http://www.mofo.com/files/Uploads/Images/110812-Loss-Absorbency-Requirements.pdf>.

⁶ http://www.financialstabilityboard.org/publications/r_101111a.pdf.

⁷ With respect to more intensive supervisory oversight, the BCBS should have provided a draft report to the FSB Supervisory Intensity Effectiveness group in June, but this report has not been made public. The FSB has said it then will issue a consultative document in December of this year. The timeline for a proposal on the strength of the financial market infrastructure is unclear. No issue-specific papers have been published, but certain aspects of the issue have appeared in various FSB papers.

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resolution. The home country regulator typically can address the issue for contracts governed by home-country law. For contracts with early termination rights but governed by host-country law, the home-country authority cannot take appropriate action. The FSB proposes four possible solutions: contractual provisions in which a counterparty agrees to abide by the resolution requirements in the home country, the grant of authority to host jurisdictions to order compliance with home-country actions, judicial action in the host country, or a full-faith-and-credit-type statute.

Strengthened national resolution regimes

The FSB Paper identifies several functions of an effective resolution regime, a list that, while not groundbreaking, is perhaps the best single summary of the need for special resolution powers for SIFIs. According to the FSB, a regime is effective if it:

- Ensures continuity of systemically critical financial services and functions
- Protects insured depositors and insurance policy holders and ensures the rapid return of segregated client assets
- Allocates losses on firm owners (shareholders) and unsecured and uninsured creditors in their order of seniority
- Does not rely on public solvency support and does not create an *ex ante* expectation that such support will be available
- Avoids unnecessary destruction of value, and therefore minimizes the overall costs of resolution in home and host jurisdictions
- Provides for speed and transparency and as much predictability as possible through legal and procedural clarity and advanced planning for orderly resolution
- Provides a mandate in law for cooperation, information exchange, and coordination domestically and among relevant foreign resolution authorities before and during a resolution
- Ensures that nonviable financial institutions can exit the market in an orderly way
- Is credible and thereby provides incentives for market-based solutions

These functions require a resolution regime with several “key attributes,” including a statute creating an authority with broad powers, requiring extensive planning for a resolution (or a recovery), and precluding, to the extent possible, the use of public funds in resolutions.

Resolution statute. To these ends the FSB recommends the enactment of a comprehensive statute governing resolutions. A SIFI would enter the resolution process when the firm is no longer viable or likely to be no longer viable and other measures have proved insufficient to prevent failure.⁸ A firm need not be balance sheet-insolvent in order to be placed in resolution.

⁸ We compare the recommendations in the FSB Paper to the Dodd-Frank resolution structure in detail below, but it bears mentioning here that the FSB proposal on the resolution trigger mirrors the statutory trigger for the receivership of insured depository institutions in the U.S. Resolution at the holding-company level of a SIFI in the U.S., however, requires a more complicated set of findings.

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Resolution authority. The statute would designate an authority with broad powers to resolve SIFIs for which it is the home-country authority,⁹ significant nonregulated operational entities within a SIFI, and branches of foreign institutions. The authority should have the legal power to enter into cross-border agreements. The authority should have unimpeded access to information from financial firms. From a political perspective, the agency should, on the one hand, have operational independence but should, on the other, be subject to rigorous evaluation and accountability. Further, the agency should be able to initiate resolution essentially unilaterally.

Resolution powers. The FSB Paper enumerates 13 powers that the resolution authority should have. Most of these powers will be familiar to those conversant in bank receivership law. The resolution authority should be able to override the rights of shareholders and to replace the board and management with an administrator. The authority should have the power to take all action necessary to wind down the firm (including the authority to repudiate contracts), to require essential services from affiliates or to obtain them elsewhere, and to sell or transfer assets and liabilities to another existing firm or to a bridge institution. Special powers will be necessary to resolve insurance firms.

Two powers, however, are new to receiverships. The resolution authority should have the ability to “bail in” unsecured or uninsured creditors, either by writing off some or all of a SIFI’s unsecured debts or by converting these creditors into equity holders. The resolution authority also should be able to enter into cross-border agreements in order to effect a comprehensive and orderly resolution. Indeed, each SIFI would be the subject of its own crisis management group (“CMG”), a group of all of the resolution authorities in all countries in which the SIFI operates, in order to ensure to the greatest extent possible that a resolution is not disrupted by cross-border issues.

Public sector support. The FSB Paper recites the now-commonplace principle that public ownership or taxpayer-funded bailouts should not be the means of financing the resolution of a SIFI. If temporary funding (i.e., public support) is necessary, then the resolution authority should have the ability to recover losses from shareholders and unsecured creditors “or if necessary, the financial system more widely.” There should also be a privately financed recovery fund or a mechanism for *ex post* recoveries from the industry.

Notwithstanding the objections to the infusion of public funds into a troubled SIFI or a SIFI in resolution, the FSB would allow for three types of government participation: temporary funding, access to liquidity from the central bank, and public ownership as a last resort, if funds later may be recovered from the industry. Temporary funding should be subject to two conditions. First, the resolution authority must make a determination that such funding is necessary to foster financial stability and will permit implementation of a plan that will achieve orderly resolution and that private sources have been exhausted or cannot achieve these objectives. Second, losses must be allocated to equity holders and residual costs allocated to unsecured and uninsured creditors and to the industry through *ex post* assessments.

Bail-in

The part of the FSB Paper most likely to generate debate is the recommendation that a resolution agency be granted, by statute, the authority to write down or convert into equity all unsecured and uninsured claims in a resolution. The FSB Paper is not the first paper in which the bail-in power has been proposed, but it has the most detailed discussion of the power to date.

⁹ The resolution authority could not resolve entities within the SIFI that are organized or operated outside the home country—hence the need for cross-border cooperation discussed below.

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- **Nature of the bail-in.** The bail-in authority should be exercised so as to achieve (or help to achieve) the continuity of systemically important functions. The forced write-down or conversion would (in theory) help to recapitalize the institution or to capitalize a new or bridge institution to which the systemically important functions have been transferred. This approach would seem to imply that the bail-in authority should not be used unless it, together with other recapitalization efforts, will result in an institution with adequate levels of capital. It is not clear that the FSB would recognize this implication, however.
- **Specific bail-in powers.** Several powers should be part of a bail-in statute. The resolution authority should be able to conduct four different types of bail-ins: (i) the write-off of equity or other instruments of ownership, (ii) the write-off of all subordinated claims, (iii) the write-off of up to all of the subordinated or senior unsecured and uninsured creditor claims against the institution, and (iv) the conversion into equity or other instruments of ownership of all or parts of subordinated or senior unsecured and uninsured creditor claims. Any credits with contractual bail-in clauses should be written off or converted before the resolution authority exercises its statutory bail-in power.
- **Early termination rights.** The statute should address early termination rights, commonly provided for in short-term financing arrangements, derivative contracts, and other financial agreements. These rights would permit a counterparty to terminate a contract when the contracting SIFI enters the resolution process. The statute should provide either that the exercise of bail-in powers does not constitute an event of default or for a temporary stay on the exercise of such rights.
- **Corporate governance.** In compelling any of these bail-ins, the resolution authority should be able to override or bypass corporate law requirements that otherwise would prevent or impede the bail-in, such as preemption rights that could require a shareholder vote before new shares are issued to the bailed-in creditors.
- **Publicly traded securities.** The statute should contain provisions relating to the trading of and disclosures required with respect to securities. These provisions are unusual, to put it mildly, for institutions subject to U.S. securities laws. The resolution authority also should be able, on a temporary basis, to suspend trading or prohibit dealing, if either would undermine the bail-in. The FSB Paper also recommends that

[i]n order to preserve market confidence, jurisdictions should provide for flexibility to allow temporary exemptions from disclosure requirements or a postponement of disclosures required, e.g., under market reporting; takeover provisions and listing rules etc. where the disclosure could affect the successful implementation of resolution measures.¹⁰

- **Protections for unsecured creditors.** The statute should provide “adequate safeguards” for unsecured creditors. The safeguards include minimum recovery rights for unsecured creditors or the right to compensation equal to what they would have received in liquidation. Post-hoc judicial review should be available. If the resolution authority bails in more debt than is necessary, these creditors should receive warrants in the institution that reflect the amount of damages. Additionally, there is some recognition of creditor priorities, but it could prove evanescent. The FSB Paper states that a resolution agency should use its bail-in power in a manner consistent with the institution’s capital structure and the priority of creditor claims. However, this constraint would not apply if it would interfere with efforts to achieve the objectives of the resolution regime.

Effective Resolutions

The FSB Paper calls for an extensive review of the existing regulatory capacity to resolve failing SIFIs effectively and preparations for resolutions under the existing regime. There are two components to this study and preparation, a resolvability assessment and an RRP. The assessment concerns the effectiveness of the resolution regime and whether changes are necessary; the RRP component addresses the probability of success with a particular resolution.

¹⁰ FSB Paper, Annex 1, § 7.5, at 28.

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The two programs will occur simultaneously, and each will inform the other. The FSB Paper explains that the resolvability assessment and the resolution planning process are a “continuous process” involving (i) qualitative assessments of whether particular SIFIs are resolvable given both the firm’s structure and the resolution regime, (ii) assessments by the CMGs of particular SIFIs of whether changes are necessary to achieve effective resolution on a cross-border basis, (iii) presentation either to the firm or to the relevant regulatory authorities of issues to be addressed, and (iv) remediation and a re-assessment of resolvability.

Resolvability assessment. The resolution authority should assess whether it can resolve a SIFI without either systemic disruption or taxpayer exposure, while protecting systemically important functions. This assessment has three objectives: to educate regulators and institutions about the systemic risk implications of resolution, to identify the factors and conditions that will affect a resolution, and to determine the specific actions necessary to achieve greater resolvability without systemic disruption or the use of taxpayer funds. The FSB Paper identifies certain steps necessary to make the assessment: determinations of both feasibility and credibility and the identification of the changes necessary to achieve resolutions without systemic risk (and a timeline for making the changes).

- **Feasibility.** This step considers whether the resolution authority has the necessary legal powers and the practical capacity to use them in order to ensure the continuity of functions critical to the economy. The FSB Paper provides an extensive list of analyses and evaluations that would be part of this study.
 - *Firm structure and operations.* The ultimate assessment here is to determine the obstacles to separating systemically important functions from the rest of a SIFI in resolution and to ensure the continuity of the functions. The assessment would depend upon the following factors:
 - *Essential and systemically important functions.* The resolution authority should determine the principal business lines and the core services of each SIFI. The authority also should assess the functions the SIFI performs for global and national financial systems and the real economies.
 - *Mapping of functions to responsible entities.* The resolution authority should identify the relationships between a SIFI’s core functions and its corporate structure.
 - *Intra-group exposures.* This analysis would consider the full range of guarantees, booking practices, and cross-default clauses among affiliates within the SIFI structure. The analysis would cover risk management, the terms of the exposures (i.e., whether they are on market terms), the ability to unwind interaffiliate agreements, and whether there are material imbalances in value across legal entities within the SIFI. The authority also should confirm that intra-group exposures are well documented.
 - *Continuity of service level agreements.* This review encompasses all outsourcing agreements and whether they include robust provisions that key operational functions would continue to be performed for a bridge bank or surviving parts of a resolved firm.
 - *Management information systems.* This part of the feasibility study considers the ability of a SIFI to deliver detailed, accurate, and timely information to support an effective resolution. Elsewhere, the FSB Paper defines prompt as delivery within 24 hours.
 - *Adequacy of MIS.* The resolution authority would evaluate whether a SIFI has systems that can provide key information—on a daily basis—regarding risk exposures, liquidity positions, interbank deposits, insured deposits, and short-term exposures to or from major counterparties. The assessment also would

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cover the continuity of MIS functions in resolution, and the capacity of MIS to deliver legal entity-specific information.

- *Prompt provision of information.* The resolution authority would assess the speed with which a SIFI could deliver information and whether there are any legal impediments to delivery.
- *Cross-border coordination.* The resolution authorities should assess whether they have the necessary legal tools and operational capacity to resolve a SIFI on an internationally coordinated basis.
 - *Domestic ability to maintain continuity.* This factor is a review of whether the resolution authority in each jurisdiction in which a SIFI operates has the powers and tools described as “key attributes.”
 - *Cross-border powers.* Here, the question is whether both home- and host-country authorities have the legal power to work together. Specific issues include whether the host countries will recognize a bridge institution established by the home-country authority, whether there is differential treatment between jurisdictions in the treatment of creditor claims, and whether the fact of a resolution in one country would have a cascading effect and could by itself trigger resolutions elsewhere.
 - *Information sharing among authorities.* This review concerns the freedom of different resolution authorities to share information and their willingness to do so.
 - *Practical coordination.* Each resolution authority would examine the adequacy of its existing cross-border agreements.
- **Credibility or systemic risk assessment.** This assessment considers the expected adverse consequences to financial stability of the resolution of a SIFI. If these consequences are unacceptable, then the resolution authority should consider measures that would mitigate the systemic impact of failure. The FSB Paper identifies three factors that go into this assessment: (i) the systemic risks inherent in the SIFI’s business profile; (ii) mitigating actions taken by the SIFI with respect to its structure, management, and resolution planning; and (iii) the robustness of the resolution strategy for the SIFI.

The FSB Paper observes that the criteria for evaluating the systemic risk of a SIFI failure “are still at a nascent stage” and thus the assessment is “largely qualitative and judgmental.” The document suggests five qualitative criteria to consider in assessing the effects of a particular resolution strategy.

- Impact on markets—the likelihood that resolution will cause disorder in financial markets, possibly because of lack of confidence or uncertainty.
 - Impact on infrastructure—problems that the resolution could cause for financial market utilities: could the resolution trigger default arrangements or deprive other financial institutions of access to such a utility?
 - Impact on funding conditions—the effect of resolution on the ability of other firms to roll over or raise funds.
 - Impact on capital—the exposure of other SIFIs to the failure of the SIFI and likelihood of a dangerous effect on capital.
 - Impact on the economy—economic channels that could be affected, particularly flows of capital and credit, and any wealth effects.
- **Improvements.** This stage consists of the conclusions about feasibility and credibility and the determination of any necessary changes.

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Recovery and resolution plans. These plans should address two possible outcomes for a troubled SIFI: its recovery or its resolution. The recovery element is the responsibility of senior management of the SIFI with review by the regulators. The resolution piece of the RRP is to be developed by the regulators with input from each institution. The division of responsibilities does not segregate the two parts of the RRP. They will be developed in tandem, and both entities will have roles in both parts. Moreover, the full RRP will inform and be informed by the authority's resolvability assessment.

- **Recovery plan.** This plan explains how, in a distressed situation, existing management can reduce the SIFI's risk profile and conserve capital. The second part is a resolution plan prepared by the regulatory authorities on the basis of information provided by the SIFI.

According to the FSB Paper, the responsibilities of senior management for a recovery plan include the establishment of a robust corporate governance structure, including the designation of a senior official with responsibility for ensuring compliance with RRP requirements and for integrating the process into the firm's overall corporate governance. MIS systems should be able to generate the necessary information. Each firm should update its recovery plan regularly, as well as when circumstances have changed materially. Management also should revisit assumptions. At the request of the regulators, the firm should be prepared to participate in stress exercises.

The FSB Paper identifies seven "essential elements" of a recovery plan:

- Triggers and escalation procedures
 - Recapitalization options.
 - Restructurings.
 - Liquidity.
 - Continuity of functions in recovery.
 - Communication strategy.
 - Concrete steps.
- **Resolution plan.** The resolution authority would have a more extensive set of tasks for this part of the RRP than the management of a SIFI has for its part. Many of these tasks are also part of the resolvability assessment, however.

There are seven elements to the resolution plan that roughly match up against the elements of the recovery plan:

- *Standards for entry into resolution.* The plan should explain the legal standards for placing a SIFI in resolution and the factual criteria that would be applied.
- *Strategies and preconditions.* This element would cover alternative approaches to the resolution of a SIFI and what preconditions would be necessary or important for the success of each strategy.
- *Impact of resolution actions on elements of the SIFI business.* The plan should address (a) whether business lines or entities can continue operations outside the resolution; (b) whether the resolution authority can prevent or limit termination rights in financial contracts; and (c) the impact on other firms and markets with similar business lines. This element also should include a comparative estimate of losses to be borne by creditors and any premium associated with a resolution strategy.
- *Sources of funding in resolution.* The resolution authority should address how resolution would be financed and the role of deposit insurance funds in the resolution.

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- *Continuing access to payment systems and trading platforms.* The plan should contain processes for ensuring such access both by a bridge or recapitalized institution and by other institutions that may rely on the SIFI for access.
- *Limited continuity of operations.* The plan should describe whether and how any internal processes or market presence should continue for the SIFI in resolution.
- *Communication and cross-border mechanisms.* The resolution authority should explain effective communication strategies and how they will ensure effective cross-border resolutions.

Cross-border cooperation

Many, if not all, SIFIs operate in several host countries, as well as their home countries. Any resolution activity in one country, even in the host country, will have legal and economic consequences in the other countries. The failure of Lehman Brothers and the related complex insolvency proceedings in several countries offer an object lesson in how not to handle cross-border issues. To allow resolution of a global SIFI in as orderly a fashion as possible, the FSB recommends that the resolution agency have broad authority to work with its counterparts in other jurisdictions.

Cross-border cooperation would be achieved through an agreement establishing a CMG for each SIFI. The elements of such an agreement, as set forth in Annex 2 to the FSB Paper, are, for the most part, prosaic and anodyne, such as broad information sharing and notifications of material events. A few specific provisions are noteworthy, however.

- The CMG should define the roles for the supervisors and the resolution agencies on both a pre-crisis and in-crisis basis.
- All signatories would participate in the recovery and resolution planning process. Each institution's RRP would be reviewed by all signatories at least annually. The RRP thus is not a document reviewed and approved solely by the home country regulator.
- The home country would coordinate the work of the CMG, including recommendations on changes in a firm to improve resolvability.
- The home country would alert other countries when it becomes apparent that a SIFI would enter the resolution regime. The home country then would take the lead on a resolution and attempt to coordinate an international response. The home country may take action as it sees fit, but should avoid actions that could trigger financial instability elsewhere.
- A host country should alert the other countries if a branch or locally organized subsidiary of a SIFI is likely to go into resolution. A home country is not barred from taking action on its own but should not preempt the resolution actions of the home country.
- The CMGA should include commitments to address legal and operational impediments to resolution, such as judicial approvals, the transferability of contracts, availability of funding, and role of deposit insurance or similar arrangements. The CMGA is not intended to resolve these issues, however.
- A CMGA is not presumptively either public or nonpublic. Under the FSB Paper, this issue would be resolved on an ad hoc basis in each CMGA. Information shared pursuant to a CMGA should be protected.

Removal of obstacles to resolution

The FSB Paper identifies four issues that could hinder the resolution of a SIFI and recommends that SIFIs be required to

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take certain actions to remove the obstacles.

- **Information systems.** A SIFI should demonstrate in its RRP that it can produce all information necessary to implement the plan within 24 hours. In order for regulators to have comprehensive information on a timely basis, a SIFI should maintain a detailed inventory of its information systems mapped to core services and critical functions. The firm also should identify any external constraints on the exchange of information among its subsidiaries.
- **Service-level agreements.** To ensure that services rendered pursuant to outsourcing arrangements may continue without disruption in a resolution, each arrangement should be governed by a service-level agreement. These agreements should include provisions that prevent termination triggered by a recovery or resolution event and that facilitate transferability to a bridge institution or third party.
- **Intra-group transactions.** On a general level, each SIFI should determine whether there are unnecessary complexities in its organization and take appropriate remedial steps. More specifically, all transactions among the members of a SIFI should be at arm's length and on market terms. A SIFI also should ensure that the separate legs of a transaction that are booked in different legal entities can be collapsed and reconstituted in a specified period of time in a single entity. The firm also should limit imbalances between the parent and its subsidiaries so as to avoid stability or capital issues when the parent comes under stress. Similarly, a SIFI should seek to limit the possibility of contagion across affiliates by avoiding or limiting cross-default clauses and similar provisions. Finally, a SIFI should explore standardized valuation methodologies for closing out derivative contracts.
- **Global payment operations.** Continuous access to financial market utilities is critical in the recovery or resolution of a SIFI. The FSB Paper recommends that each SIFI assess what additional requirements for membership in a financial market utility (such as increased collateral or prefunding of positions) would apply in crisis situations and to develop appropriate options for addressing these requirements. Some SIFIs are not direct FMU participants but have access through a direct participant; these SIFIs should have a contingency plan to work with other direct participants if the first one fails. SIFIs that are direct participants and provide services to other firms (not limited to other SIFIs) should review their arrangements to ensure that they can facilitate the switching of access in the event of failure.

RESOLUTION PROPOSALS IN THE U.S. AND THE U.K.

SIFIs must consider the FSB Paper in light of developments in the U.S. and the UK. In the U.S., Title II of Dodd-Frank establishes an orderly liquidation authority managed by the Federal Deposit Insurance Corporation.¹¹ Section 165(d) of Dodd-Frank requires each SIFI (as defined in Dodd-Frank) to prepare a resolution plan which has resulted in the U.S. Proposal. In the UK, the UK Paper sets forth some other thoughts on resolutions and resolution plans. The fundamental policies underlying resolutions are the same in the FSB Paper and Dodd-Frank, but there are important differences in implementation, including:

- **Universe of SIFIs.** There is not a uniform international definition of SIFIs; the U.S. definition seems considerably broader than that proposed in Europe. Accordingly, institutions based in Europe would not be subject to the rules proposed in the FSB Paper but nevertheless would be subject to U.S. requirements and proceedings.
- **Bail-in.** The FSB Paper recommends that resolution authorities be granted, by statute, the power to write off or convert into equity all unsecured debt. The UK Paper discusses the concept as well, although it does so very much on the basis of issues for discussion rather than setting out detailed proposals. Dodd-Frank does not grant this power to the FDIC, and it is highly unlikely that Congress would ever consider attempting to do so.
- **Resolvability assessment.** Each resolution authority would be required to assess whether it could successfully resolve a SIFI—that is, effect a resolution without disruption to other institutions or the financial system as a whole.

¹¹ Pub. L. No. 111-203, 124 Stat. 1376, 1442 (July 21, 2010).

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U.S. regulators seem to interpret resolvability differently. The time frame for the resolvability assessment appears to differ as between the FSB Paper and the UK Paper.

- **Scope of a resolution plan.** The kind of resolution plan conceived of by the FSB and the FSA is broader than a section 165(d) plan. The FSB RRP would include recapitalization strategies for troubled but not failing SIFIs. The UK Paper takes the same approach. The U.S. Proposal does not itself call for a recapitalization plan, but such a plan may be captured by other U.S. requirements.
- **Review.** The U.S. Proposal includes a formal review process for resolution plans, including new restrictions on SIFIs that file deficient plans. The FSB and UK Papers have no comparable formality and are clear that the development of an RRP is an iterative one. U.S. regulators have said publicly that the U.S. process will be iterative as well, but the proposal itself does not convey this message.

Under the U.S. Proposal, a resolution plan will be rejected if it is “not credible or would not facilitate an orderly resolution.”¹² A SIFI whose plan is rejected has 90 days in which to submit a new plan. If the resubmission too is rejected, then the FRB and FDIC may impose potentially onerous requirements, including more stringent capital, leverage, or liquidity requirements or restrictions on growth, activities, or operations. The SIFI may bring these more onerous requirements to an end by filing an acceptable resolution plan. If it has not done so within two years, the Federal Reserve Board (“FRB”) and the Federal Deposit Insurance Corporation (“FDIC”) may order divestitures of assets or operations. Of course, in their traditional supervisory roles and outside the four corners of the rule, the FRB and FDIC may impose essentially the same requirements. Similarly, European regulators could achieve the same ends, but the FSA and UK Papers do not describe a specific set of more stringent requirements.

- **Credibility.** One criterion in the resolvability assessment described in both the FSB and UK Papers is the “credibility” of a resolution. A resolution is credible if the act of resolution itself does not have adverse systemic consequences. Section 165(d) of Dodd-Frank uses the same term as a criterion for an acceptable resolution plan, but neither it nor the proposed rule offer any definition or explanation.
- **Cross-border issues.** As U.S. and European regulators consider the resolution of a failing SIFI, international cooperation is inevitable as well as essential. But there are different starting points that could affect the efficacy of early-stage planning. The FSB and UK Papers discuss international cooperation at some length and emphasize the importance of global resolutions. Both papers also provide for institution-specific crisis management groups. The U.S. approach to this kind of cooperation is not so clear. The U.S. Proposal expects specific resolution plans from the U.S. subsidiaries or branches of foreign SIFIs, and the one nod to cross-border issues is that the U.S. plan explains how it is integrated into the overall resolution planning process. Section 175 of Dodd-Frank does provide broadly for coordination of policy between the U.S. and foreign regulators relating to highly leveraged and interconnected financial companies.
- **Branch offices of foreign banks.** Although this issue ultimately may prove more a matter of form than substance, the U.S. Proposal is clear that all banking organizations with more than \$50 billion in consolidated assets (wherever located) and with at least one branch office in the U.S. must submit a resolution plan. The UK Paper explicitly takes the opposite view. The FSA will not require a submission from any foreign branch, although it expects to see the plan submitted to the home country regulator. The FSB Paper is somewhere in the middle: a single RRP will be required for a multi-national SIFI, but host countries will participate in the review of the RRP.
- **Custodial Functions.** The FSA proposes that all financial firms in the UK that conduct custodial functions prepare an RRP that explains how assets will be returned promptly to customers in the event of resolution. The requirement is not limited to institutions that are systemically important, although the FSA’s initial view is that the requirement should be limited to firms with assets exceeding £15 billion. No comparable custodial-only plan is suggested in either the FSB Paper or the U.S. Proposed Rule.

¹² The formality of the US process may be driven by the Administrative Procedure Act. The U.S. Proposal is not explicit on this point, however.

Client Alert.

- **Disclosures.** The FSB Paper recommends that the resolution authority have the ability to delay disclosures otherwise required for publicly traded securities. Dodd-Frank is silent on this point, and it is highly unlikely that the U.S. would ever grant such power to the FDIC.

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