



Living Wills: Public Portions Released

Banking organizations required to file resolution plans, or “living wills,” received some additional instruction this past Tuesday, July 3, 2012, when the Federal Deposit Insurance Corporation (“FDIC”) and the Federal Reserve Board (the “Board”) released the public portions of the living wills that had been submitted on July 2, 2012. These submissions marked the first wave of filings, those by nine banking institutions with U.S. operations and \$250 billion or more in nonbank assets.

The living wills are required by section 165(d) of the Dodd-Frank Act, and the requirement extends to all banking organizations with \$50 billion or more in consolidated assets. The \$50 billion threshold applies to assets located outside the United States as well as within; as a result, more than 90 foreign banking organizations (“FBOs”) are expected to file resolution plans.¹ The next wave of filings will come ashore on July 1, 2013, when banking organizations with \$100 billion or more in total nonbank assets must submit living wills. The remainder of the organizations subject to the requirement must submit living wills by December 31, 2013.²

Since the plans that were submitted on July 2 reflect at least some preliminary discussions with the FDIC and the Board, future filing institutions should be able to draw several lessons from the public portions of the July 2 filings, as follows:

- A resolution strategy will be based in part on assumptions provided by the FDIC and the Board. For this wave of filings, the assumptions appear to have been somewhat optimistic, and in any case may limit the scope of a resolution analysis.
- The fundamental decision for a U.S. banking organization is whether the FDIC should or should not create a bridge company in order to resolve the organization in the most cost-effective manner.
- A banking organization must be able to identify which subsidiaries would retain value and provide liquidity in distressed circumstances.
- A solid understanding of the bankruptcy framework and its practical application is essential.
- An appropriate corporate governance structure and robust management information systems are critical parts of a resolution plan.

¹ Apart from this \$50 billion threshold, all other asset calculations for living will threshold purposes are based on an FBO’s total U.S. nonbank assets only.

² In addition, the FDIC requires insured depository institutions with \$50 billion or more in consolidated assets (“covered insured depository institutions” or “CIDI”) to file resolution plans. A CIDI’s plan may be consolidated with the living will filed by its holding company.

- The interplay between resolution activities in the United States and those in foreign countries is critical for any U.S. organization or FBO, but it appears to be primarily an issue for home- and host-country bank regulators to address.
- The organization or format of a resolution plan is somewhat different from that outlined in the final regulation governing living wills.

Statutory and Regulatory Background

The stated purpose of a living will, according to the Dodd-Frank Act, is to explain how the filing organization can be resolved in a “rapid and orderly manner” if the organization is in material financial distress or is failing. This purpose subsumes three separate objectives of the living will: (i) to explain how the filing organization can manage itself and return to health if it becomes distressed; (ii) to provide a road map for liquidation by the FDIC if the organization is placed in receivership under the Orderly Liquidation Authority; and (iii) to enhance supervision by the Board by providing additional detail on how an organization views the risks within it.

Since the publication of the final living will regulation, the Board, the FDIC, and the Office of the Comptroller of the Currency have released other regulations and guidance that will inform the resolution planning process. These include a final rule on capital plans—which are explicitly designed to work in conjunction with living wills—stress testing guidance, and proposed “enhanced prudential standards” that, among other things, involved greater attention to liquidity. The proposed U.S. regulatory capital standards that were issued in June eventually will factor into resolution plans as well.

A comprehensive and meaningful living will requires extensive confidential proprietary information. The regulation recognizes this fact and protects this information in the same way that the banking agencies protect other confidential information of their regulated entities under the Freedom of Information Act. The public portion of a resolution plan accordingly omits any such confidential information. The content of the July 2 plans should allay for the time being any concerns that the FDIC and the Board may require the public summary to include any proprietary information that has not or would not be disclosed in periodic filings with the Securities and Exchange Commission.

The July 3 Public Portions

Nine banking organizations—five headquartered in the United States and four domiciled abroad—filed living wills on July 2. The five U.S. organizations also filed CIDI plans, although in all but one case the CIDI plans were incorporated into the organization-wide living will.

Assumptions underlying the resolution strategy

While the living will regulation requires a banking organization to develop its own assumptions on stress scenarios and the possibility of capital raising or the sale of operations or assets, the FDIC appears to have provided a common set of baseline assumptions to filing organizations. The FDIC assumptions are as follows:

- Sudden, idiosyncratic material financial distress occurs at the institution with no previous disruption to the markets.
- All material entities have entered some form of bankruptcy.
- Markets are functioning normally.
- Other market participants are in good financial condition.

- Funding markets are open for other market participants.
- No extraordinary government support is being provided.

These assumptions have important ramifications for any resolution strategy. The assumptions contemplate only institution-specific financial distress. If, for example, the distress is idiosyncratic, then there likely will be able and willing purchasers of any material entities or assets, even if potential purchasers require some funding in order to do so. Indeed, under this scenario, an institution still might have some access to capital or funding. Alternatively, however, if the institution has placed (or creditors have forced) all material entities into bankruptcy, the options for the institution will be extremely limited. How or whether the regulators will address or will expect filing institutions to address more system-wide distress—as we recently experienced in the financial crisis—remains unclear. As a result, the current filings provide only limited insight into what the form and content of a more interesting resolution plan—that which assumes systemic financial distress—would look like.

That said, this set of assumptions appears to be a starting point for the FDIC and the Board. Once a banking organization must consider a system-wide collapse, rather than idiosyncratic distress, the number of different scenarios mushrooms, substantially more data will be necessary, and the analysis of potential strategies will be wider-ranging. The regulators do have to start somewhere, and this set of assumptions represents the first step in what is likely to be a longer, iterative process with the regulators.

Resolution strategy and the formation of a bridge company

One open issue that the plans mention and that is not dictated by any assumption is whether a bridge company would be an effective resolution mechanism. In this respect, the resolution plans filed by the nine banking organizations on July 2 do not approach this issue uniformly. In any event, this decision ultimately will be one for the FDIC rather than an individual organization. The underlying analysis will rely heavily on confidential institution-specific information and accordingly is not available in the public portions. Therefore, it will be advisable for future filers to analyze with care the economics of a bridge company in their particular circumstances.

Valuation and disposition of material operations

A resolution strategy certainly will be based on an organization's view of the risks presented by the operations or entities that constitute a material part of the economics of the organization, how those could be funded in the event of distress, and whether any of the business lines could be sold at a reasonable value. The significance of the July 2 plans is that they appear to concentrate more carefully on these issues than one might infer from the substance requirements of the living will regulation. Future filers should be prepared to address issues surrounding each of their material business lines at a granular level.

Reliance on U.S. bankruptcy process

All of the plans describe strategies involving extensive use of Chapter 7 and Chapter 11 proceedings at the parent company and nonbank subsidiary levels. Indeed, the scenario described by the FDIC on which the resolution plans rest includes an assumption that all of the material entities of a banking organization will have entered bankruptcy. Accordingly, all filers, but especially those with material, nonbank lines of business, should be sure to engage outside advisers that are experienced in the legal and financial aspects of the bankruptcy process.

Corporate governance and MIS

The first eight of the 11 parts in the public portion could be drawn almost entirely from other public disclosure documents. The remaining three could not. Accordingly, the discussions in the public portions of the July 2 plans

may be helpful to future filers, even though the discussions do not contain proprietary information. The three parts include, in addition to the resolution strategy, the corporate governance structure for addressing resolution issues and the institution's MIS capabilities to support decision making in connection with financial distress and resolution planning. These are, of course, basic elements of a successful resolution. Accordingly, any filer should be prepared to address all three of these items with care. Specifically as to corporate governance, even the public portions of the July 2 plans describe their structure and processes with a fair amount of detail. These descriptions should be a model for future filers, although the July 2 plans do not set forth identical forms of corporate governance.

Interplay with foreign resolution regimes

The resolution of an FBO or a U.S. banking organizations with material subsidiaries organized abroad will involve foreign as well as U.S. proceedings. The public portions of the July 2 resolution plans, including those that were filed by the four FBOs, do not provide any specifics as to the interplay between proceedings in different jurisdictions. In turn, these fairly sparse descriptions support the view that the relationships between various proceedings have yet to be determined. These relationships are beyond the reach of any private organization and will have to be addressed by the U.S. regulators, separately and in consultation with their foreign peers. The international supervisors, through the Financial Stability Board, are continuing their work on the development of an effective cross-border resolution framework for globally significant financial institutions but so far do not appear to have moved beyond a broad statement of general principles. The FDIC and other U.S. regulators are engaged in discussions with their foreign counterparts on this issue, and the roles of different jurisdictions should be clarified over time.

Organization and Format

From an organizational perspective, the living will regulation requires eight sections.³ A review of the July 2 plans suggests that the FDIC and the Board have revised the plan format to include 11 parts. The filing organizations describe these 11 a little differently, but in substance a plan should provide, in order, the following: (i) the names of material entities; (ii) a description of core business lines or business segments; (iii) a summary of financial information regarding assets, liabilities, capital, and major funding sources; (iv) a description of derivative and hedging activities; (v) a list of memberships in material payment, clearing, and settlement systems; (vi) a description of foreign operations; (vii) identification of material supervisory authorities; (viii) a list of principal officers; (ix) the resolution planning corporate governance structure and processes related to resolution planning; (x) a description of material management information systems; and (xi) a high-level description of resolution strategy.

Conclusion

Although the public portions of the resolution plans that were filed on July 2, 2012, do not give much indication of exactly how any of those filing organizations might be resolved, they do contain important information for those organizations required to file resolution plans next year. The organization of the plans and some of the choices in the nature of the plans provide some indication of the FDIC's and the Board's expectations for these plans. At the same time, the resolution plan process is an iterative process. There is the possibility that as these plans are reviewed and analyzed by the FDIC and the Board, changes in the form and content of these plans may be required for these and future resolution plan filers.

³ These are (i) an executive summary, (ii) a strategic analysis, (iii) a description of corporate governance relating to resolution planning, (iv) the organizational structure and related information, (v) a description of MIS, (vi) a description of interconnections and interdependencies, (vii) supervisory and regulatory information, and (viii) contact information.

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