Davis Polk McKinsey&Company

CREDIBLE LIVING WILLS: THE FIRST GENERATION

Davis Polk & Wardwell LLP and McKinsey & Company[1]
April 25, 2011

Executive Summary

The post-financial crisis era has seen a paradigm shift in the regulation of the financial services industry. Systemically important financial institutions are becoming subject to new regulatory requirements in multiple areas including increased capital and liquidity requirements, mandatory stress tests, restrictions on their activities, higher prudential standards and recapitalization or wind-down mechanisms. Enhanced planning for the risk of failure is an important element of the new regulatory paradigm. Supervisors from the United States, the European Union and the Group of Twenty (G20) are developing requirements for systemically important financial institutions to create credible living wills. These plans will include key information about the firm and set forth actions that could be taken to reduce idiosyncratic losses and to mitigate systemic contagion in the event of financial distress, up to and including the insolvency or failure of the firm.

In some ways, living wills are analogous to contingency planning for public emergencies that arise when a hurricane, earthquake or other natural disaster strikes. Even though human choices are the underlying causes of financial panics, financial panics are also like natural disasters because they have occurred repeatedly, suddenly, unpredictably and destructively throughout the history of financial markets. The rationale behind the living will is that, like contingency planning for an emergency, pre-planning could reduce the likelihood of future crises or at least enhance the ability of firms and supervisors to respond to a crisis. A concern with the living wills process is that, like a poorly designed contingency plan, it could be used to impose changes that are intended to reduce systemic risk but which are neither risk mitigating nor efficient.

Living wills, if designed and implemented properly, have the potential to be a highly effective tool for improving risk management, reducing systemic risk and mitigating the too big to fail and too big to save problems. Specifically, they have the potential to:

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- **Enhance risk management capabilities**. Requirements for living wills may prompt firms to raise the bar on the quality of their risk information and management information systems, their risk and scenario analyses and their contingency planning, all of which may have benefits even in the absence of a crisis.

- **Improve risk mitigation**. Advance planning could help firms to take mitigating actions to avoid failure and to reduce the contagion impact of an institution's failure on the rest of the financial system and the real economy. These benefits come from putting processes in place to identify risk concentrations in advance, by developing capital or liquidity contingency plans that help stave off insolvency or illiquidity in the event of adverse market conditions and from identifying and reducing internal and external impediments to swift action in a time of crisis.

- **Increase market confidence**. Market awareness of the existence of living wills and the possibility of a resolution may increase confidence in systemically important financial institutions, in particular as a result of greater collaboration among supervisors.

There are, however, several drawbacks and risks associated with living wills that need to be carefully considered. The practical impact of these risks depends on the skill with which supervisors and firms design and implement living wills. Drawbacks of particular concern include:

- **Managing the business for failure**. Severe limits on risk-taking could limit firms' ability to take prudent and appropriately-priced risks, and thereby reduce their ability to meet the needs of a global economy. Financial institutions take prudent risks as part of their everyday business. For example, maturity transformation—widely viewed as perhaps the most socially useful function of financial intermediaries—involves significant risk-taking. Managing the firm for failure may prevent the many social and economic benefits of managing it for success. If living wills are used primarily as a supervisory tool to severely limit risk-taking to reduce the likelihood of failure or to restructure an organization to be optimal for failure, the practical impact could be to place too many restrictions on firms' ability to take prudent and appropriately priced risks or mandate a structure that is suboptimal for success. Just as failure creates a cost to society, restricting prudent risk-taking or mandating structures that are suboptimal for success also creates costs ultimately borne by society in the form of a decreased supply and increased cost of credit and lower economic growth. Making financial institutions completely safe from failure is neither possible nor desirable from an economic perspective.

- **Increased instability**. Planning and structuring businesses primarily with the objective of mitigating domestic risk and facilitating local resolution procedures could have the perverse side effect of making banks less able to respond to a crisis due to immobile capital and liquidity and reduced netting and efficiency benefits. To the extent that capital and liquidity are blocked within national subsidiaries, the flexibility of a firm to manage risk centrally within the organization or to move capital or liquidity where it is needed and when it is needed the most will be reduced, and the efficiencies which facilitate the availability of credit globally will be eliminated. Also, if living will requirements force a firm to book transactions into entities based on non-business criteria, then they could reduce netting benefits, thereby increasing net exposures and ultimately increasing risk within the firm.

- **Creating a costly white elephant**. If living wills are inconsistent with optimal risk and return management principles, or are misaligned with the actual way that failures are likely to occur or the legal regimes under which they will be resolved, then there is a real risk that living wills become expensive projects with no practical value beyond compliance for its own sake. Worse, if multiple supervisors in one or more countries have conflicting objectives and issue conflicting directives based on their analyses of the information in the living wills, firms will not only incur costs to reconcile these conflicts but could also face greater uncertainty and instability in a financial crisis.

Getting living wills right both domestically and globally is a critical, high-stakes problem both for supervisors and regulated institutions. We believe that a good outcome depends on following six guiding principles regarding how living wills should be designed:

- **Living wills should be harmonized and coordinated across supervisors and jurisdictions**. Responsibility and oversight for cross-border firms should be clearly designated. Regulators should coordinate their activities to permit firms that do business in multiple jurisdictions or have entities subject to a variety of insolvency laws to create a unified master living will, reflecting all the different insolvency laws that will or could apply to various entities and operations. It would be inefficient for complex global institutions to create multiple, overlapping and inconsistent living wills for their major operating subsidiaries. Instead, the home country supervisor, or a designated committee of supervisors acting jointly, should be given primary authority for evaluating and approving a master living will that has subcomponents for major operating subsidiaries in all relevant countries and under all relevant insolvency laws, each one of which is aligned to, and works with, the whole. By identifying areas where there are conflicts among jurisdictions or applicable insolvency laws, living wills can also prompt such coordination. In the absence of a binding international agreement, international supervisory coordination and harmonization of resolution regimes by the G20 will be critical for globally active firms.

- **Living wills should be risk-based and fully consider the firm's business model**. A wide variety of types of firms with very different business models will be required to produce living wills. Living will requirements for a given type of systemically important institution (*e.g.*, bank vs. non-bank financial company, specific business model followed, historical risk-based performance of business) should be designed in a manner that is aligned with the risk profile and performance of the institution and the risks that the institution may pose to the system. The crisis has taught us the risks financial firms take are idiosyncratic—not all firms take the same types of risks or will perform the same under stress—and credible living wills should reflect this reality. As one example, the degree to which a firm's portfolios is accounted for on a mark-to-market basis, as opposed to historical cost accounting, has implications for the proper crafting of a living will. It will impact, for example, the degree of static vs. dynamic information, the necessary triggers, the window of time for recovery and the resolution actions to be implemented. It is imprudent and expensive to prepare for earthquakes in Miami, Florida, or for hurricanes in San Francisco, California, and to do so would divert resources and attention away from preparing for the most likely and significant potential sources of distress.

- **Living wills should be closely integrated with other required regulatory processes and core risk management processes**. Existing regulatory and risk management processes, tools and requirements should be extended to and integrated with the development of the living will, to ensure that the plan builds upon and enhances ongoing business and risk management procedures and is not duplicative of, or in conflict with, such procedures. For example, stress testing and the development of risk appetite may contain information important to the development and implementation of a proper living will. Both risk appetite and stress testing have been the subject of numerous regulatory requirements, and the living will should build on these existing processes and requirements. Such integration will also ensure that living wills reflect the latest development of risk management capabilities and practices within firms. Supervisors can also reduce duplication and increase efficiency by reviewing stress testing, risk appetite and other inputs into the living will as part of the stress testing supervisory process, and not repeating that review as part of the supervisory review of living wills.

- **Recovery and resolution plans should be considered on a continuum with risk management and take into account the stages of a potential crisis**. The credibility of recovery and resolution plans should be evaluated in the context of an overall crisis management framework that begins with risk management and crisis avoidance, moves to recovery planning and ends with resolution planning. In particular, resolution plans need to consider that recovery actions will likely have been attempted before resolution actions are taken, and, as a consequence of these efforts, the institution is likely to have different assets, capital, funding needs and impacts on the broader financial system by the time of resolution than it would have in a normal financial environment.

- **Credible living wills require careful iteration**. It should be recognized that the contents of living wills will and should be allowed to evolve through an iterative process, and the credibility of living wills should be evaluated in that light. Resolution planning for complex global financial institutions has never before been attempted, and the task is intrinsically difficult given the nature of the problem and the various impediments. Through the first generation, firms and supervisors therefore should focus on identifying as fully as possible impediments—internal and external to the firm—that are likely to be resolved only over several examination cycles by, among other things, upgrading management information systems and reporting, updating data, coordinating regulatory regimes and tailoring bankruptcy and resolution procedures. Externally imposed structural and organizational changes should not be a first resort, especially in light of the significant costs.

- **Living wills are not a panacea**. Living wills are not easy to implement effectively, and are unlikely to succeed in isolation. No one can reliably predict the trigger event or the timing of the next crisis ahead of time. Moreover, resolution planning in particular is far removed from the actual potential source of the crisis, which will almost always be driven by excessive risk taking. Each firm's own business and risk management should be the first lines of defense, with prudential supervision as a second line of defense. Living wills cannot solve all the too big to fail or too big to save hazards, nor can they be expected to operate perfectly in the real world. Living wills are one step along the way to such a system, which also includes contingent capital, recapitalization and a robust bankruptcy or resolution regime that must transcend national borders.

Based on these guiding principles, in this paper we set forth an end-to-end template for a credible living will that proposes eight core elements of a unified master living will and conforms to the six fundamental principles we have laid out. Such a living will would address:

- Institution overview
- Business strategy and risk management
- Governance and oversight
- Information management and availability
- Stress testing and scenario planning
- Triggers and thresholds
- Recovery planning, including contingent liquidity, capital and business actions
- Resolution plan requirements, including cross-border resolution actions

Based on what we know, even in the absence of final regulatory guidelines, there are clear actions that firms and supervisors could take now to facilitate the creation of useful living wills.

Firms can:

- **Upgrade and improve any risk management building blocks** for the living will that may warrant further strengthening, and put in place the right leadership, resources and governance to manage the living will process and integrate it into going concern risk-management practices;

- **Identify needed improvements to the mid- and back-office infrastructure,** especially in risk data architecture, documentation, counterparty and collateral information across legal entities, risk aggregation and analysis, both legal and financial, and risk reporting; and

- **Analyze the current legal and operational structures** for opportunities to simplify where there is no material business or risk management rationale for the complexity of the current structures, and to identify interdependencies among entities through, for example, service agreements, intergroup guarantees, split hedges and cross-default clauses.

Supervisors can:

- **Recognize and address confidentiality concerns about living wills**, including potential negative impacts of disclosure or access within the firm itself, to competitors and to customers and counterparties;
- **Identify and develop detailed and robust methodologies and requirements that differentiate** among business models and firms based on type and level of risk; and
- **Coordinate more closely with their national and international counterparts** on the approach to handling inter-agency and cross-jurisdictional differences and defining common objectives, including with respect to living wills and resolution procedures.

The stakes for credible living wills are high for all involved—firms, supervisors and households and businesses in the real economy. The issues are too important to rush to conclusions without careful consideration, not only to ensure that living wills are implemented in the best possible way, but also to maximize the chances that they actually accomplish their goals of reducing systemic risk, enhancing value and avoiding or mitigating any immediate or lasting harm to the real economy when a disaster in the form of a financial crisis strikes.

The remainder of this paper describes in more detail our proposed guiding principles, the core elements that a living will should contain and the steps that firms and supervisors could take now despite the absence of final regulatory requirements.

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I. Fundamental Principles for Living Wills

In light of the potential benefits and downsides of a living will, we propose six fundamental principles for firms and supervisors to incorporate into their living will programs. Although the proper implementation for individual firms will vary, we believe that these principles are widely applicable and that supervisors and firms would benefit from adopting them in the development of credible, effective living wills.

1. *Living wills should be harmonized and coordinated across supervisors and jurisdictions*.

We believe that complex firms should be required by national and international supervisors to produce a single unified, or master,[2] living will that has various subparts for major subsidiaries that each connect to the master. In addition, the living will should be designed, implemented and evaluated for credibility as a unified whole. International coordination among legal regimes and supervisors in developing a framework for the resolution of a cross-border institution is at a very early stage and may not develop. It is likely, however, that any significant future financial institution resolution will be spread out over multiple countries and involve multiple sets of supervisors, each with their own sets of requirements and preferred approaches.[3] In light of the global operations of the world's largest financial institutions, we do not see any other realistic scenario. The Lehman bankruptcy is the case-in-point for the difficulties in an era of globally interconnected systemic firms.[4]

- **Unified road map to recovery and resolution**. Complex global firms whose operations span across many borders and regulators will be required to develop living wills that take into account separate major subsidiaries.[5] Given the reality

[2] The use of the term "master" is an analogy to ISDA master agreements.

[3] Indeed, at a national level, there are few jurisdictions which even have a framework designed specifically for the resolution of domestic financial groups. BASEL COMM. ON BANKING SUPERVISION, BANK FOR INTERNATIONAL SETTLEMENTS, REPORT AND RECOMMENDATIONS OF THE CROSS-BORDER BANK RESOLUTION GROUP 18 (2010) [hereinafter BASEL REPORT]. Combined with the fact that different jurisdictions are contemplating different approaches for resolution and recovery planning, there is a high likelihood that national supervisors will differ in the approaches that they take in a crisis.

[4] The Basel Committee on Banking Supervision reports that the Lehman Brothers group consisted of 2,985 legal entities that operated in 50 countries. Supervisors in the United States, United Kingdom and assorted other countries were not always able to come to agreement, both about whether Lehman could be saved in its final moments and, after it had failed, about how the insolvency proceedings should proceed, resulting in difficulties with the wind-down and problems in returning client assets. BASEL REPORT at 14–15.

[5] Currently, the EU Commission is considering whether EU parent financial institutions or EU financial holding companies should be required to draw up a group recovery plan that includes recovery plans for each group entity. DIRECTOR-GENERAL INTERNAL MARKET AND SERVICES, TECHNICAL DETAILS OF A POSSIBLE EU FRAMEWORK FOR BANK RECOVERY AND RESOLUTION (2011) [hereinafter EU FRAMEWORK]. Under the EU model, plans would be shared with a consolidating supervisor and relevant subsidiary supervisors. The consolidating supervisor should then take into account the views expressed by other supervisors when assessing the plan. *Id.* at 20–22.

The FDIC and Federal Reserve's joint proposed rule on resolution plans contemplates that covered foreign firms will provide most of the required information solely with respect to subsidiaries, branches, agencies, critical operations and core business lines that are domiciled or conducted in whole or material of resources at both regulators and firms, we suggest that it would make sense, in the first generation of living wills, to prioritize which subsidiaries would be the subject of such sub-living wills. The master living will would aggregate information across the group structure regarding risk management, information systems management, stress testing and recovery planning in a single document. Without such an approach, a broad range of institutions will be faced with a cacophony of supervisory requirements and priorities, and conflicting solutions to impediments, as well as overlapping and inefficient mid- and back-office infrastructure changes and proposed investments.

- **Increased fragmentation could increase risk**. The greater risk is that supervisors will be primarily concerned with protecting their national interests and those of local stakeholders and that a territorial approach will predominate, with local supervisors introducing ring-fencing over local assets and liabilities.[6] Fragmentation of this sort may have the perverse effect of increasing global systemic risk. A fragmented approach could lead to a lack of coordination in solving for internal and external impediments, unclear priorities for management information system investments and unclear signals about whether the supervisors would implement the plans as designed. If living will requirements force a firm to book transactions into entities based on non-business criteria, then they could reduce netting benefits, thereby increasing net exposures and ultimately increasing risk within the firm.

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part in the United States. FDIC & Fed. Reserve Sys., Resolution Plans and Credit Exposure Reports Required, 76 Fed. Reg. 22648, 22656 (proposed Apr. 22, 2011) (to be codified at 12 C.F.R. pts. 252 & 381).

Moreover, firms within their own country are likely to find their living wills evaluated for credibility by multiple domestic supervisors bringing to the process different policy goals and agendas. For example, in the U.S., the Federal Reserve and the FDIC will jointly evaluate the credibility of resolution plans of non-bank financial companies mandated by Section 165(d) of the Dodd-Frank Act, the FDIC and either the Federal Reserve or the OCC will share the responsibility for evaluating the credibility of living wills prepared by subsidiary banks, and the FDIC and any number of state and federal financial regulators will share the responsibility for evaluating the credibility of any contingency planning or living will of non-bank financial companies that is required as a matter of supervisory discretion (separate from Section 165(d) of the Dodd-Frank Act).

[6] INDEPENDENT COMMISSION ON BANKING, INTERIM REPORT: CONSULTATION ON REFORM OPTIONS (2011). There are many different types of ring-fencing under consideration, which could have different types of impact in a crisis. For example, the UK's Independent Banking Commission (ICB) is "considering forms of retail ring-fencing under which retail banking operations would be carried out by a separate subsidiary within a wider group." *Id.* at 8. The ICB's April 2011 interim report acknowledges that although such ring-fencing would "entail costs to banks, some of which fall on the wider economy," those costs "appear to the Commission to be outweighed by the benefits of materially reducing the probability and impact of financial crises." *Id.*

Supervisors may also use ring-fencing to impose asset pledge or asset maintenance requirements, or to limit inter-affiliate transactions, including transfers of assets, and may institute planning requirements that institutions prove that their assets in the particular jurisdiction always exceed their liabilities. BASEL REPORT, *supra* note 3, at 16.

The U.S. national depositor preference law—which gives domestic deposit claims priority over foreign deposit claims and the claims of general creditors—is also a form of domestic ring-fencing that various countries have adopted or may adopt. *See* National Depositor Preference Amendment, Pub. L. No. 103-66, § 3001(a), 107 Stat. 312, 336 (1993) (codified as amended at 12 U.S.C. § 1821(d)(11)); *see also* INDEPENDENT COMMISSION ON BANKING, *supra* note 6, at 75.

- **Coordinated evaluation of the living will**. A unified living will, with appropriate accommodations and deference by interested supervisors, could mitigate these concerns. A global master living will could be segregated into various sub-plans to be viewed by the regulators in relevant jurisdictions, while the unified whole could be reviewed by the primary supervisor to assess the overall credibility of the plan across jurisdictions. Coordination among national and international supervisors is clearly required for such an approach, and such dialogue would be at its most valuable now, as concrete requirements for living wills are just beginning to be developed.

2. Living wills should be risk-based and fully consider the firm's business model.

That living wills should be influenced by and based on risk seems like a straightforward principle. However, a truly risk-based approach has considerable implications for the supervision and development of credible living wills, many of which have not been apparent in the discussion and debate thus far. A one-size-fits-all approach is likely to be both inefficient and ineffective.

- **Differentiate credibility standards and requirements across different types of business models**. There is likely to be a wide variety of types of firms that will be required to prepare living wills. In the United States, for example, regulators could require living wills from commercial banks with a retail focus, commercial banks with both a retail and a wholesale focus, custody banks, investment banks and broker-dealers, insurance companies, hedge funds, non-bank finance companies and others. Credible resolution plans for these different types of business models could be very different. Even the basic types of information required to understand the material risks faced by a firm will differ for institutions that are more exposed to market risk, or use mark-to-market accounting, from those that are more exposed to credit risk or use historic cost accounting. The speed at which risk exposures and valuations change or are reflected in financial disclosure varies greatly from one type of business to another. Living will requirements should recognize these and other meaningful differences and address them appropriately, in a way that does not penalize one type of firm or another.

- **Differentiate credibility standards and requirements based on riskiness**. Among the many lessons of the crisis, one of them is that even ostensibly similar businesses can perform very differently under adverse conditions. Risk appetite, risk culture, and management practices within institutions have enormous impact on performance and safety and soundness. Supervisors should consider evaluating living wills giving explicit consideration to the firm's business risk profile, capital adequacy and financial condition, as evidenced both by its past performance and its current risk profile.

- **Account for the potential sources of material distress**. Understanding the source of likely material financial distress is critical to proper recovery and resolution planning. Without having a view into the possible sources of distress, or the pace at which financial distress could develop, one cannot describe actions that would be appropriate or feasible. Recovery and resolution planning must be closely linked to an understanding of the specific vulnerabilities of a given institution, and to analytical frameworks such as stress testing. Resolution planning for firms is akin to disaster preparedness for a municipality—the type of potential disaster is critically important to making the proper plans. It is imprudent and expensive to prepare for earthquakes in Miami, Florida, or for hurricanes in San Francisco, California. To do so would divert resources and attention away from preparing for the most likely and significant potential sources of financial distress.

3. Living wills should be closely integrated with other required regulatory processes and core risk management processes.

Many of the component parts of a credible living will can leverage analyses, processes and plans that firms will already have in place, such as stress testing, credit exposure analysis and contingency planning. The living will should use existing processes in the firm to the extent possible. Requirements for producing a living will should be tightly integrated and consistent with other regulatory requirements to ensure that the living will is an extension of ongoing business and risk management processes, and is not duplicative of, or in conflict with, such efforts. In particular, supervisors should coordinate living will requirements with other related supervisory requirements being imposed in the form of enhanced prudential regulation, systemic regulation and international standards.[7]

For example, stress testing and the development of risk appetite may contain information important to the development and implementation of a proper living will. Both risk appetite and stress testing have been the subject of numerous regulatory requirements, and the living will should build on these existing processes and requirements. Such integration will also ensure that living wills reflect the latest development of risk management capabilities and practices within firms. Supervisors can also reduce duplication and increase efficiency by reviewing stress testing, risk appetite and other inputs into the living will as part of the stress testing supervisory process, and not repeating that review as part of the supervisory review of living wills.

4. *Recovery and resolution planning should not be viewed as separable activities but as part of a continuum.*

Living wills should be viewed as part of a crisis management continuum that begins with crisis avoidance including prudent risk management, moves next to recovery planning and ends with resolution planning at the highest end of the severity scale.[8] Some have suggested that there should be a clear bifurcation of recovery plans and resolution plans,

[7] The Office of Financial Research, for example, has issued a proposal on the development of uniform legal entity identifiers. Dept. of the Treasury, Office of Financial Research; Statement on Legal Entity Identification for Financial Contracts, 75 *Fed. Reg.* 74146 (Nov. 30, 2010). Firms should work to identify areas of overlap stemming from requirements that are complementary to living wills not just in their aims to manage systemic risk, but also in the burdens they impose on firms. Regulators should encourage this process and attempt to eliminate overlapping requirements and resolve potentially conflicting requirements.

[8] At a Federal Reserve and FDIC-hosted roundtable on living wills with industry representatives, Chris Jones of Bank of America set out this template for living wills. *The Federal Deposit Insurance Corporation Holds a Forum for Discussion of the Dodd-Frank Resolution Plan*, LexisNexis at *4 (Nov. 4, 2010) (statement of Chris Jones, Bank of America) (LexisNexis, CQ Transcriptions database) [hereinafter *Living Wills Roundtable*].

with the recovery plan created by the firm and the resolution plan created by the regulators and not necessarily shared in its totality with the firm.[9] We believe this approach to be dangerous and impractical. We believe that the far better approach is to view recovery and resolution plans as part of an integrated whole that operates on a crisis management continuum and presents multiple options and paths.

- **Begin with crisis avoidance and risk management**. Crisis avoidance, which includes the day-to-day risk management of the company, begins with true risk transparency, a defined risk appetite, risk monitoring, such as stress testing and scenario analysis, and strong risk governance.[10] For living wills to be meaningful, they should build on the core risk and business management practices of the firm—effectively integrating these activities into a cohesive whole—rather than being just a *de novo* or stand-alone exercise.

- **Resolution actions will be preceded by recovery actions**. Resolution scenarios are unlikely to arise spontaneously; they will be preceded by recovery actions undertaken by firms voluntarily or pursuant to regulatory requirements.[11] If the recovery plan is not successful, the firm's resolution plan, providing the information necessary to wind-down the institution in resolution, would be invoked.[12] Further, the execution of a living will might occur amidst a systemic crisis, or could be the result of an event that is idiosyncratic to a particular firm. Available resolution options will vary depending on the path by which a firm arrives at that point and the circumstances in the market at the time of resolution. As a result, resolution plans should not be expected to provide a predetermined path, but rather should provide options and flexibility and should be evaluated in light of the inherent variability in the environment and uncertainty around future crises.

- **Uncertainty at the resolution end of the spectrum**. Resolution planning requires thoughtful consideration of how a line of business or branches could be wound-down by the supervisors, and what the impediments to that wind-down

[9] The FDIC has stated that a systemically important firm will be required to create a plan for resolution under the U.S. Bankruptcy Code, but that the FDIC will create and maintain a separate plan for resolving such a firm under the Orderly Liquidation Authority, Title II of the Dodd-Frank Act. Andrew Bailey of the Bank of England has also supported this model for dividing responsibilities. Andrew Bailey, Executive Director, Banking Services and Chief Cashier, Bank of England, Recovery and Resolution Plans, Remarks at the Santander International Banking Conference, Madrid (Nov. 17, 2009).

[10] *Living Wills Roundtable*, *supra* note 8, at *4.

[11] *E.g.*, pursuant to Section 166 of the Dodd-Frank Act, the Federal Reserve must prescribe regulations to provide for the early remediation of financial distress of companies subject to the statute's living wills requirement.

[12] Although the Dodd-Frank Act's resolution plan requirement contemplates a credibility check assuming wind-down under the Bankruptcy Code, nothing precludes a firm from also including in its plan alternative strategies that would be available under non-bankruptcy resolution regimes. *See* Dodd-Frank Act § 165(d)(4) (requiring the Federal Reserve and FDIC to jointly consider whether a resolution plan would facilitate an orderly resolution under the Bankruptcy Code). Artificially restricting the legal regimes under which resolution would be assumed to occur could lead to an expensive and irrelevant exercise.

would be.[13] In some instances, institutions may be able to address potential impediments to resolution, but even where that is not possible, it will be important for the institution and the supervisor to be aware of the impediment.[14] Because a firm's ability to predict and pre-plan the course of its own wind-down is necessarily limited, supervisors should acknowledge the uncertainty that surrounds the resolution end of the risk management continuum and evaluate the credibility of living wills accordingly.

5. *Credible living wills require careful iteration*.

Supervisors are beginning to roll out the specifics of proposed living will requirements,[15] and we expect that the coming months and years will be an intense learning period for both firms and supervisors.

- **The credibility of the initial set of living wills should be evaluated as first generation living wills**. Both the sophistication of firms' living wills, and their usefulness as a supervisory tool, should evolve and improve over the next several exam cycles as part of an iterative process of learning and reflection by both the supervisors and institutions. What is credible in the first round may well not be credible several years later. Supervisors such as Acting Comptroller of the Currency John Walsh have recognized the "novelty of the undertaking" and have said that "the process will need to be flexible and dynamic."[16] The generational concept is in line with the fact that supervisors will require firms to update their living wills on a regular basis and also after major corporate events;[17] however, we believe such updating requirements should be undertaken at a pace that allows true learning and progress over an appropriate period of time.

[13] Firms will need to evaluate the impediments to a resolution assuming that key decisions about which assets and liabilities to transfer to a bridge institution must be made in a short weekend that begins with the close of business in the United States on Friday, and ends with the open of business in Asia on Monday (which is still Sunday in the United States).

[14] Of course, some impediments may be worked out over time, and to that extent, a living will generates an action plan for changes that are internal to the firm, such as management information systems or legal structure changes, and those that are external, such as market infrastructure changes.

[15] *See, e.g.*, Press Release, FDIC, FDIC Board Approves Joint Proposed Rule on Resolution Plans and Credit Exposure Reports for Covered Systemic Organizations (Mar. 29, 2011).

[16] At the FDIC Board meeting approving the release of the joint FDIC and Federal Reserve rule proposal on living wills, Acting Comptroller of the Currency John Walsh, who is also a member of the FDIC Board, commented that "The rule appropriately contemplates an iterative process to develop initial plans and continuing dialogue to keep them relevant as was discussed in the presentation. And it will be important to recognize that the range of acceptable outcomes may be large and we shouldn't really be expecting or seeking plans that fit a single approach or framework." *The Federal Deposit Insurance Corporation Board of Directors Hold an Open Session,* LexisNexis at *17 (Mar. 29, 2011) (statement of John G. Walsh, Acting Comptroller of the Currency) (CQ Transcriptions database).

[17] FDIC & Fed. Reserve Sys., Resolution Plans and Credit Exposure Reports Required, 76 Fed. Reg. 22648, 22656 (proposed Apr. 22, 2011) (to be codified at 12 C.F.R. pts. 252 & 381) (proposing to require annual submission of resolution plans, as well as interim updates following any event, occurrence, change in conditions or circumstances or other change that results in, or could reasonably be foreseen to have, a material effect on a previously submitted resolution plan).

- **Resolution planning is an intrinsically difficult task.** Resolution planning for complex global financial institutions has never before been attempted, and the task is intrinsically difficult given the nature of the problem and the various impediments. Living wills are an attempt to plan for future crisis scenarios, the triggers and timing of which are inherently difficult to predict. Success requires having sufficient advance warning of the firm's financial distress to take required recovery (and if unsuccessful, ultimately resolution) actions, but crises do not follow a set schedule and may arise like a hurricane, earthquake or tsunami without substantial warning. This is not to excuse any culpability of the financial institution in the causes of a crisis, but rather to emphasize the sudden and dramatic nature of a crisis. Living wills, properly implemented, will attempt to anticipate possible risks and estimate the firm's resiliency to a crisis, but there is no guarantee that they will be executed in a manner that actually mitigates a crisis.

- **Identify internal and external impediments to an orderly resolution**. The focus for the first generation of living wills should be on compiling the relevant data about the firm and evaluating it to determine internal and external impediments to an orderly resolution. The process of data compilation and analysis is likely to reveal specific impediments to recovery and resolution planning that a given firm faces, some of which will reside within the institution, and some of which will be external. Internally, for example, firms are likely to identify inadequacies in their technology and management information systems. First generation living wills should identify these weaknesses and outline strategies to correct them, including infrastructure development, which cannot be done overnight. More problematic will be impediments that arise as a result of market structure, clearinghouse rules, clearinghouse risk management weaknesses, inadequacies in relationships or contractual terms with critical third-party service providers and vendors or difficulties in planning for resolution under multiple insolvency laws. Because these types of issues are not entirely within the control of individual firms to promptly remedy, there is an even greater need for early identification and planning.

- **Living wills as part of an ongoing dialogue with and among supervisors**. This view of living wills as part of an iterative process also highlights the fact that living wills should involve more than the preparation and filing of a document. It is expected to promote an ongoing dialogue between the financial institution and its supervisors (and among the supervisors) in various jurisdictions, but should not become a roadblock to the day-to-day management of an institution. The iterative approach advocated here avoids the risk that a living will requirement becomes a costly white elephant, created to meet a statutory requirement but not integrated into the risk management and other processes within the institutions. Worse yet, the living will exercise could result in costly and inefficient requirements imposed on institutions if such a dialogue is not part of the process. Such a result is more likely if supervisors impose a structure on institutions rather than using feedback and experience to inform the structure and processes. A first generation living will may not provide all the answers, but it should identify major issues and a firm's plans for working through them.

6. *Living wills are not a panacea*.

Achieving orderly resolution of systemically important financial firms in the midst of a financial crisis is a formidable challenge. Living wills are only one part of a system for orderly resolution. For example, establishing a credible orderly resolution process is also a fundamental issue.[18] Moreover, resolution planning in particular is far removed from the actual sources of crises, which makes the plans less effective at meeting their intended goal of limiting damage to individual firms, the financial sector, and the real economy. Living wills also may impose real trade-offs between maximizing productive activities and making the firm and system safer.

- **Only one element of a larger framework to be developed over time**. Key policy decisions around and elements of the new regulatory infrastructure—such as the appropriate or not uses of contingent capital, bail-ins or recapitalizations, the appropriate or not uses of subsidiarization or ring-fencing[19] and international coordination around resolution[20]—are not yet in place.[21] Each of these will, over time, be critical components of living wills or critical action items derived from the information contained in the living wills. All of this calls for a measure of prudence in the implementation of any individual piece of the overall framework, such as living wills.

- **Greater safety comes at a cost**. We believe the goal of financial regulation should be to balance safety with productive activity. We recognize that the interests of firms and supervisors may diverge at times, yet at a more fundamental level, it is in the long-run interest of both firms and supervisors to balance safety with value creation.[22] There may be apparent tensions as a result

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[18] *See* Randall D. Guynn, *Are Bailouts Inevitable?*, YALE J. ON REG. (forthcoming Winter 2011); John L. Douglas & Randall D. Guynn, *Resolution of US and Other Financial Institutions*, *in* DEBT RESTRUCTURING 311, 370 (Look Chan Ho & Nick Segal consultant eds., Oxford Univ. Press 2011) .

[19] The questions of how ring-fencing of assets for national creditors or the use of national subsidiaries might be a preferred tool for crisis management but a capital and liquidity trap during normal times is a major one and highlights one of the inherent tensions about the use of living wills as a supervisory tool. Sheila Bair has noted that large multinational financial institutions with complex legal structures will need to simplify their operations. "The burden is on them initially to show us that they don't think they need subsidiarization," she said. "They need to give us a plan on how they can be resolved on an international basis without it." However, as John Douglas, a former General Counsel of the FDIC, noted in the same article, "If you set up a business in a way to optimize ease of liquidation, that may not be the way to optimize running a successful business." Dave Clarke, *FDIC Calls for Big Bank Restructuring*, REUTERS, Mar. 1, 2011.

Subsidiarization, or ring-fencing, should be distinguished from the type of simplification of legal structures (*e.g.*, reducing 5,000 subsidiaries to 500) that both firms and supervisors can agree on as having considerable benefits. *See infra* Part III.

[20] See *infra* Part III for recommendations pertaining to cross-border coordination.

[21] *See, e.g.*, INDEPENDENT COMMISSION ON BANKING, *supra* note 6, at 76 (asking whether "bank debt should be made more loss-absorbing using some or all of contingent capital, bail-inable debt and/or depositor preference").

[22] It is impossible, and ill-advised, to attempt to make financial service firms completely safe, as the socially optimal number of failures and crises must be higher than zero, if there are costs to crisis prevention. *See* Guynn, *supra* note 18.

> of firms' and supervisors' differing mandates—firms plan for recovery and resolution with the goal of maximizing shareholder (and later, creditor) value, while supervisors are more likely to focus on the systemic impact of an individual firm's failure—with the result that firms may feel themselves pushed towards managing their business for failure, rather than maximizing value.
>
> A more nuanced view of managing for failure, however, would recognize that limiting the systemic impact of the failure of a financial institution requires that supervisors seek to also maximize value for creditors and other stakeholders in the event of a failure. Failing to do so may give creditors and counterparties a powerful incentive to flee from firms at the first sign of weakness, which would be further destabilizing in a market crisis situation.

Supervisors should proceed deliberately and thoughtfully to avoid not just those unintended outcomes with obvious systemic implications,[23] but also those supervisory issues, such the protection of confidential information,[24] with equally significant systemic consequences.

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[23] *See, e.g.*, *supra* note 19. Supervisors should also take care that living will requirements do not reward firms that are poorly-integrated or poorly-managed from a risk, systems, personnel or liquidity perspective and that, as a result, may seem easier to break-up and sell in a wind-down scenario.

[24] For example, in order for living wills to be credible and complete and to encourage an open discussion between the firm and its multiple regulators, there must be a zone within which the highly competitive and sensitive information in the living will would be viewed as confidential supervisory information. Careful thought needs to be given to the use and misuses of the U.S. Freedom of Information Act in this respect and the differences in how other countries may view the privacy of this information. In the U.S., information in the possession of a government agency is typically subject to FOIA, which places an affirmative obligation on federal agencies to make agency records available to the public unless one of nine enumerated exceptions applies. The scope of the various FOIA exemptions has been defined by judicial precedent with imperfect clarity, and leaving the new issue of confidentiality of living wills to the courts raises uncertainty. For a more in-depth discussion, see Annette L. Nazareth & Margaret E. Tahyar, *Transparency and Confidentiality in the Post-Financial Crisis World—Where to Strike the Balance?*, HARVARD BUS. L. REV. (forthcoming Spring 2011).

II. Core Elements of a Recovery and Resolution Plan

The core elements of our framework include:

1. Institution Overview
2. Business Strategy and Risk Management
3. Governance and Oversight
4. Information and Counterparty Management and Availability
5. Stress Testing and Scenario Planning
6. Triggers and Thresholds
7. Detailed Recovery Plan
    - Business Actions
    - Contingent Capital Actions
    - Contingent Liquidity Actions
    - Other Contingent Actions
8. Detailed Resolution Plan
    - Internal and external impediments to resolution
    - Applicability of different legal regimes
    - Cross-border resolution actions

In this part of the paper, we identify and discuss the core elements of an end-to-end template for a credible living will that combines both recovery and resolution planning.

1. Institution Overview.

Information about business lines, legal entities, internal and external interconnections and exposures, funding and liquidity and other topics form the foundation of an effective recovery and resolution plan. Foundational information falls into two broad categories: static and dynamic.[25] Static information includes descriptions of the company's business (*e.g.*, major business lines and legal entities, mid- and back-office functions, ownership information, jurisdictional and supervisory information and financial and operational interdependencies between affiliates).[26] Supervisors have emphasized the need for information to be harmonized into a coherent overall picture of business lines and legal entities.[27]

Dynamic information includes information that changes in real time, such as exposures to major counterparties (and vice versa), intercompany lending between core and critical businesses, funding and liquidity, assets and liabilities, an unconsolidated balance sheet and a consolidating schedule and available lines of credit and current positions with exchanges, clearinghouses and custodians and other significant financial companies.

Because the dynamic information will be specific to a particular point in time, the living will generally should not include specific exposures but rather provide references or access to databases and reports where up-to-date information can be obtained as well as details around how the information is maintained and kept up-to-date.

2. Business Strategy and Risk Management.

Crisis planning needs to begin from an understanding of the risks that the firm faces. For supervisors to properly evaluate the credibility of a living will, the living will needs to describe the firm's business strategy, the major types of risks taken, and the firm's risk management practices. The objective is to identify the types of financial, economic or other conditions that would endanger the firm's viability, and thus to highlight the most relevant

[25] Daniel K. Tarullo, Member, Board of Governors of the Fed. Reserve System, Remarks at the Symposium on Building the Financial System of the 21st Century: An Agenda for Europe and the Financial States: Toward an Effective Resolution Regime for Large Financial Institutions 10 (March 18, 2010).

[26] Such "static" information is not really static in the business environment. We use the terms "static" and "dynamic" to distinguish between information that is susceptible to quarterly or annual updates and information that changes on a daily basis.

[27] Tarullo, *supra* note 25, at 10.

circumstances in which recovery or resolution activities could be necessary. This section is closely related to, and therefore should be tightly integrated with, the institution's risk management processes such as the risk appetite definition and risk reporting.

3. Governance and Oversight.

Governance and oversight relating to living wills must be defined clearly. First, the living will should specify roles and responsibilities for creating, approving and updating the plan. By its nature, the living will draws on a number of inputs from functions such as risk, legal, finance, IT and business units. The creation and ongoing updating of the living will require assignment of a working team. Because of the sensitivity of information, access to the complete living will should be controlled. Overall, the living will process and output should be supervised by senior management and overseen by the Board of Directors.

In addition, the living will should define specific governance and oversight processes that could take effect during a recovery or resolution situation. For example, financial institutions may define emergency measures that take effect once triggers have been breeched, such as reductions in leverage or risk taking and enhanced rules for communicating with internal and external stakeholders during a crisis. Moreover, the firm should describe the governance around those triggers and the resulting recovery or resolution actions.

4. Information and Counterparty Management and Availability.

One lesson of the 2008 financial crisis was that firms did not adequately maintain, and were not immediately (or over a weekend) able to access, critical counterparty and collateral information.[28] Compiling the information required for a living will is likely to require significant upgrades to existing management information systems and documentation of mid- and back-office infrastructure. For example, the living will could describe the system by which legal entity, agreement, transaction, perfection of security interests and other information has been coded and is retrievable, and could describe the relevant management information systems and identify key reports generated by the firm.

5. Stress Testing and Scenario Planning.

Stress testing and scenario planning, a key element of the new systemic regulatory regime, are a crucial underpinning of the integrated recovery and resolution plan. Stress testing provides a forward-looking indicator of potential sources of distress and the firm's resiliency in the face of adverse conditions. As such, stress testing helps to clarify the type of stress that would place the institution in a recovery or resolution situation, and could be

[28] *See* LEHMAN BROTHERS INC. TRUSTEE'S PRELIMINARY INVESTIGATION REPORT AND RECOMMENDATIONS 113 (2010) ("The Trustee was handicapped in his administration of the liquidation by the . . . inability to locate basic documents and information. This lack of basic information would also make it difficult for potential acquirers of customer accounts to perform due diligence or understand the nature of the accounts potentially subject to transfer. Even something as simple as mapping the customer accounts explaining and identifying the account ranges and agreements associated with them, the applicable systems and box locations, and the collateral associated with them was lacking."); *see also Implications of the "Volcker Rules" for Financial Stability: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 111th Cong. (2010) (statement of E. Gerald Corrigan, Managing Director, Goldman Sachs & Co.) [hereinafter "*Corrigan Testimony*"].

used as an input in developing triggers for recovery and resolution. It is important to note that many firms already have supervisory requirements to conduct stress testing—the living will should incorporate and leverage existing processes. However, it is important that existing stress test capabilities be sufficiently robust to support the living will—for example, that the selection of scenarios adequately considers the key risk exposures of the firm. We believe that building the ability to generate a broad range of stress scenarios of various degrees of severity and to translate them through a combination of models, historically guided judgment and qualitative reasoning is therefore critical to a credible living will.

6. Triggers and Thresholds.

Building on the components of the living will already discussed, such as the stress testing results and the risk appetite, the living will could define observable triggers that would allow the firm to consider activating components of its recovery or resolution plans. Triggers may be useful as objective indicators of distress that signify the need for further examination as to whether recovery or more serious resolution actions are warranted.

7. Recovery Plan Activities.

Once defined signals appear, the firm needs a menu of available actions, such as contingent liquidity plans, contingent capital plans and plans for business and asset sales. Because the exact crisis situation is unknowable ahead of time, such actions should preserve management flexibility and optionality to choose those options that are appropriate under the specific crisis situation. Significant firms already plan for contingencies as part of their day-to-day management (*e.g.*, liquidity and capital contingency plans); however, there may be an opportunity for firms to enhance these contingency plans.[29] For example, firms should recognize and develop action plans to address crisis-specific issues such as the fact that the value of the firm's assets and businesses will decline as the firm's financial weakness becomes more obvious and the need for a sale becomes more urgent, the fact that the firm's funding capacity will decline in such scenarios as counterparties refuse to provide liquidity and that its franchise value will decline as customers flee.[30]

8. Additional Resolution Plan Requirements.

Financial institutions should focus on identifying activities whose on-going availability is critical to the financial system and macroeconomy. We believe that in the first generation living wills other noncritical activities should be excluded from the initial recovery and resolution planning process, except those required to support systemic functions (*e.g.*, central operations and technology functions).

Firms should also consider and discuss with supervisors the impact and potential impediments of the application of various resolution tools (*e.g.*, partial transfers, whole bank transfers and bridge financial companies) and different legal regimes. They should consider the way in which such resolution mechanisms interact with other regulatory tools, such as

[29] Thomas F. Huertas, Director, Banking Sector, FSA, and Alternate Chair, EBA, Living Wills, How Can the Concept be Implemented? Speech at the Wharton School of Management, University of Pennsylvania (Feb. 12, 2010).

[30] Christine M. Cumming, First Vice President, Fed. Reserve Bank of N.Y., Remarks on Early Intervention and Resolution at the Transatlantic Corporate Governance Dialogue 5 (Oct. 25, 2010).

stress tests and supervisory examinations, on both a domestic and international basis.[31] Finally, globally connected financial institutions will have to make assumptions regarding actions that may be taken by national authorities in a crisis. Supervisors are focused on the international problems associated with a cross-border resolution, and firms should be planning in the same context.[32]

III. Next Steps for Firms and Supervisors—"No Regrets Actions"

In light of the principles we have suggested for developing living wills, and despite the absence of final regulatory requirements, we suggest that there are certain "no regrets" actions that firms and supervisors can, and should, take now. These actions are consistent with the issues that firms and supervisors will have to grapple with as they move ahead with the living wills implementation, regardless of what shape the requirements may ultimately take.

Firms should in particular:

- **Evaluate their risk management building blocks, and upgrade those areas that may warrant further strengthening**. Firms may be able to identify changes that can be made now, and systems that can be made more robust, to the extent that they are not doing so already. It is important for firms to develop forward-looking measures of solvency and liquidity, so that they have a window of time during which to implement their recovery plans. These types of upgrades have obvious benefits for going-concern risk management, living will requirements notwithstanding.

  In addition, firms can start to identify the core group that will be responsible for developing the living will within the institution and shepherding that process through the institution. Because of the highly sensitive nature of the information, this is likely to be a small, high-level group of people, and assembling that team provides an early start that most firms can undertake now.

- **Identify needed improvements to the mid- and back-office infrastructure**. Management information systems is an early focus for living wills across jurisdictions, as current, accurate and relevant information is seen as the key to being able to manage a systemically important financial institution in a financial crisis, and if necessary, through a resolution. Improvements in such infrastructure offer the potential for enhancing overall risk management if they are done correctly and proper scoping and definition could make them more than cost-effective.

  For example, former New York Federal Reserve Bank President Gerald Corrigan has argued that a systemically important firm needs to have or develop the ability to quickly and accurately aggregate its overall exposure to various credit, market, liquidity and counterparty risks and to aggregate collateral exposure across

[31] Tarullo, *supra* note 25, at 8.

[32] Dave Clarke, *FDIC Calls for Big Bank Restructuring*, REUTERS, Feb. 28, 2011; HER MAJESTY'S TREASURY, ESTABLISHING RESOLUTION ARRANGEMENTS FOR INVESTMENT BANKS 125 (2009).

disparate lines of business, and to provide a view both at the consolidated level and by legal entity.[33]

- **Review their legal and operational structures with a view to identifying opportunities to simplify where there is no material business or risk management rationale for the complexity of current structures**. Identifying obvious redundancies or inefficiencies in the legal and operational structures within an institution is an easy start to the living wills planning process. As a result of mergers, acquisitions or other business changes, certain legal entities may no longer serve a purpose within an institution, but with no impetus or need to evaluate and simplify, those entities may remain as costly legacies within the institution. The current legal entity structure for many firms may not be an intentional design, effective, required for the business activities of the firm or cost effective when all costs are considered. The living will exercise can serve as such an impetus to evaluate the legal entity structure and where appropriate, simplify the structure, and to identify interconnectedness among entities through, for example, service agreements and intergroup guarantees. Firms that undertake legal entity and structure optimization programs have found opportunities to reduce expense by streamlining the legal entity structure without a meaningful impact on their business. As one example, a large international bank was able to reduce by more than 20% their number of operating legal entities and capture expense savings from the corresponding reduction in audits, regulatory and tax filings and financial reporting.

Supervisors could in particular:

- **Coordinate more closely with their national and international counterparts on the approach to handling inter-agency and cross-jurisdictional differences.** Given the global nature of the operations of systemically important financial institutions, it is likely that any significant future financial institution resolution will be spread out over multiple jurisdictions and involve multiple sets of supervisors, each with its own set of requirements and preferred approaches. Supervisors for different regulated entities, including the broker-dealer, bank subsidiary and bank holding company, should coordinate in their approach to resolution and to living wills requirements and be clear about objectives. Supervisors across jurisdictions should also begin the dialogue for agreeing on an approach to living wills for such complex, cross-border institutions. Learning from the Lehman experience,[34] it is clear that a greater degree of regulatory

[33] *Corrigan Testimony*, *supra* note 28, at 44. Section 165(d) of the Dodd-Frank Act requires certain systemically important firms—in addition to producing resolution plans—to report periodically on (1) their credit exposures to other significant nonbank financial and bank holding companies and (2) the credit exposures of such significant companies to them. *See also* FDIC & Fed. Reserve Sys., Resolution Plans and Credit Exposure Reports Required, 76 Fed. Reg. 22648, 22658 (proposed Apr. 22, 2011) (to be codified at 12 C.F.R. pts. 252 & 381).

[34] The bankruptcy of Lehman Brothers in 2008 made clear the difficulties associated with winding-up a globally interconnected financial institution. According to the Basel Committee on Banking Supervision, the Lehman Brothers group consisted of 2,985 legal entities that operated in 50 countries. Supervisors in the United States, United Kingdom and assorted other jurisdictions were not always able to come to agreement, both about whether Lehman could be saved in its final moments and, after it had failed, about how the

coordination would facilitate both the actual recovery and resolution process and the institution's planning for such eventualities.[35]

A best case international recovery or resolution would be a universal or at least a coordinated territorial approach, involving the home country supervisor making coordinated decisions on an international level. However, as was the case with Lehman, there is a risk that supervisors will be primarily concerned with protecting their national interests and those of local stakeholders and that an uncoordinated territorial approach will predominate, with local supervisors introducing ring-fencing over local assets and liabilities rather than deferring to home country supervisors.[36] Moreover, without pre-coordinated action, supervisors for local jurisdictions may have incentives in a nascent crisis to act early in seizing assets, thereby precipitating an otherwise avoidable demise. Without coordination among supervisors and across jurisdictions, there is a risk that in a resolution, the living will may be meaningless, or worse, that fragmentation will result in conflicting and irreconcilable demands on the institution. Supervisors should communicate about their coordination in order to provide the market necessary assurances.

- **Identify and develop methodologies and requirements to differentiate by risk among different types of business models**. Supervisors should recognize that different types of institutions, and different business models among the same type of institution, present different risk profiles. The living will requirements, and the consequences that flow from those requirements, should differentiate by types of business models. What will be appropriate for a non-bank, global systemically significant financial institution may not be appropriate for a domestic bank holding company. The living will should provide transparency into a firm's risk profile to clearly link the institution's business strategy and its broader approach to enterprise risk management. Without such tailoring, the requirements will be too broad or too narrow to be effective.

- **Recognize and address confidentiality concerns about living wills**. Supervisors should recognize and address confidentiality concerns about the sensitive portions of living wills. Living wills are likely to require institutions to provide granular information about their operations, including core businesses,

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bankruptcy should proceed, resulting in difficulties with the wind-down and problems in returning client assets. BASEL REPORT, *supra* note 3, at 14–15.

[35] Encouraging steps toward such coordination include a joint memorandum of understanding between the FDIC and the Bank of England agreeing to exchange information and cooperate in the resolution of a cross-border insured depository institution. FDIC & Bank of England, Memorandum of Understanding Concerning Consultation, Cooperation and the Exchange of Information Related to the Resolution of Insured Depository Institutions with Cross-Border Operations in the United States and United Kingdom (Jan. 10, 2010). However, there is at present no framework for the resolution of cross-border financial groups, although the EU has circulated a draft for consultation. EU FRAMEWORK, *supra* note 5.

[36] *See, e.g.*, *supra* note 6. Supervisors may use supervisory ring-fencing to impose asset pledge or asset maintenance requirements, or to limit inter-affiliate transactions, including transfers of assets, and may institute planning requirements that institutions prove that their assets in the particular jurisdiction always exceed their liabilities. BASEL REPORT, *supra* note 3, at 16.

critical operations, trading books and counterparty exposures in the name of recovery and resolution planning. However, regulators should also realize that this information could expose institutions to serious competitive, political or other harm or even destabilize national or global financial systems if improperly disclosed to the public, particularly at a time when its highly contingent relationship to results of operation or financial condition means that it is not necessarily material to shareholders and creditors. Therefore, we recommend that supervisors carefully design confidentiality regimes.[37]

Thoughtful Consideration of Disclosure and Confidentiality. Regulators should specify how highly sensitive confidential portions of the mandated resolution plans, which are highly contingent, would be treated. There will, of course, be questions that firms will have to face on the extent to which applicable securities laws might require certain information in their resolution plans to be disclosed to the public. But disclosing such information because the information is material to investors is very different from situations in which the act of disclosing the information is itself adverse to the company and its investors because, for example, the disclosure disrupts the internal operations of the company, harms its competitive position or subjects it to exploitation by unregulated competitors.

International Regulatory Coordination. For living wills to be credible and complete and to encourage an open discussion between the firm and its multiple regulators, there should be a zone within which the highly competitive and sensitive information in the living will would be viewed as confidential supervisory information. Regulators in each jurisdiction will need clear policies and procedures in place before their counterparts in other jurisdictions can be comfortable engaging in open dialogue regarding living will specifics, and vice versa.

Rules of the Road Needed. Resolution plans will involve complex issues of the timing of any disclosure under securities laws and the scope of confidentiality of shared data by U.S. and foreign regulators, as well as the consequences for valuation and diligence related to acquisitions, sales and capital markets transactions. Depending upon the securities laws of the listing jurisdiction, firms may decide that they are required by disclosure principles to inform their shareholders and creditors about the outlines of their plan or about the occurrence of events under the plan. Supervisors should expect these difficult issues of materiality to be worked out over time and to be heavily fact and context dependent. We do not view it as optimal or desirable if they will lead to the entire plan becoming known to the public and competitors.

Conclusion

The stakes are high for developing credible living wills that will enhance risk management at firms, mitigate the systemic impact of weakness at any single systemically important financial

[37] In addition to FOIA concerns, *see* Nazareth & Tahyar, *supra* note 24, supervisors should consider the implications of the restrictions in many countries on information-sharing across borders.

institution, and increase overall market confidence in both times of crisis and under normal market conditions. If not implemented properly, living wills may not only become costly white elephants, but also could increase systemic instability and lead to unnecessary credit contraction and unnecessarily higher credit costs. It is too important to rush to conclusions without careful consideration that ensures that living wills are implemented in the best possible way, and maximizes the chances that they will reduce risk and enhance value.

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