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Living Wills: Key Lessons from the First Wave for Second and Third Wave Filers

The first wave filers – the largest and most complex domestic and foreign bank holding companies – have now filed their living wills and the public portions have been posted on the FDIC's and the Federal Reserve's websites. Based on our experience advising a number of banking institutions on their resolution plans, and based on the public portions of the plans, we believe there are lessons to be learned for second and third wave filers, even in this early stage of an iterative process. At the same time, these lessons should be drawn carefully in light of the fact that the business models and legal structures of the second wave filers are somewhat different from the first wave filers, and those of the third wave filers are very different. Any lessons learned from the first wave should also be tempered by the fact that the standard format for the living wills that the regulators required in the first wave is likely to change for second and third wave filers. With that in mind, we suggest the following key lessons from the first wave filers based on what is known immediately after their public filings.

- **The Regulators Are Still in Learning Mode and Standards Are Still Evolving.** Resolution planning is as new to the regulators as it is to the banking sector, and many staff at different levels of both the Federal Reserve and the FDIC are involved. In addition, for some banking institutions, international regulators are also part of the discussion. We expect that second and third wave filers will benefit from the regulators' increased experience, including improvements in the standardized format for filing that was required of the largest bank holding companies as well as increased consistency in the messages about expectations.
- **Resolution Planning Will Continue to Evolve After the Initial Submissions.** Resolution planning will take more than one year to fully develop. As noted in the public portions, in the first wave the regulators provided baseline assumptions including:
  - No exercise of the recovery plan;
  - An idiosyncratic scenario specific to the banking institution that does not affect the global financial markets generally;
  - The baseline stress assumptions from the Federal Reserve's stress tests;
  - All material entities have failed; and
  - No reliance on extraordinary government support.

  It is expected that in future years the required economic scenarios will become more stressed. This expectation of different assumptions in later years means that senior management should look ahead to how different resolution plan strategies might fare in a more stressed environment and possibly adjust resolution planning accordingly.
- **Resolution Planning is Driven by Legal Entity Not Business Units.** Banking institutions are business lines in life but are legal entities at death. This fundamental mismatch between the most efficient way to manage a business and create shareholder value and the most efficient way to resolve it at the point of non-viability requires a temporary paradigm shift by business leaders. We believe it is best to first develop a preliminary top-down resolution strategy by focusing both on how systemic risk can be minimized and how the value of the business lines can be preserved in a resolution that occurs on a legal entity basis. This requires, as a first step, that core business lines, critical operations, critical services and shared services be mapped to legal entities. The

second step is to map each material legal entity to its applicable insolvency regime and to evaluate the interactions of the legal regimes and other resolution processes as well as major impediments by considering the fate of the core business lines, critical operations, critical services and shared services on a legal entity basis. Prepare for some surprises in the interconnections and interdependencies among legal entities. These unexpected interconnections and interdependencies will reveal the risks of what might be cut off during a resolution proceeding.

- **Create a Preliminary Top-down Strategy First and Then Create the Focused Data Gathering Plan.** Resolution planning is data heavy, and the FDIC and Federal Reserve regulations require a rich array of data. This data will have to be gathered, be evaluated and be reliable not only every year but also after a material change in the banking institution. Our experience is that it has been more efficient for a banking institution to first develop a well-defined top-down resolution strategy on a preliminary basis before beginning the data-gathering process. That strategy can later be changed if the data provides a different picture than expected. Without an initial overarching strategy, however, there is a risk of expensive back-tracking or the gathering of data that is neither relevant nor useful. The data-gathering plan during the first year should create processes that are repeatable and that can become systems-driven in later years.
- **Internal Education and Buy-in at an Early Stage Makes for a Less Intrusive and More Efficient Process.** Key people in the business units should be educated about the objectives of resolution planning and the entity-by-entity nature of the process before being asked to provide input. This means that some initial education, including senior business manager involvement from the critical business units and demonstrated support from top corporate management, will save time and make the process for creating the resolution plan much more efficient in the long run.
- **There Are a Finite Number of Resolution Strategies.** There are only a limited number of resolution strategies. As included in the public portions and discussed publicly by the regulators, they include:
  - The sale of assets and business lines, either before a bankruptcy proceeding or under the supervision of the bankruptcy court;
  - The recapitalization of the insured depository institution outside of an FDIC receivership;
  - The purchase and assumption of some or all of the assets and liabilities by a third party buyer out of an FDIC receivership;
  - The creation of a bridge bank for the insured depository institution followed by a sale or public offering, or a recapitalization of the bridge through a conversion of debt for equity; and
  - An orderly wind-down.
- **There are Many Ways to Mix and Match Resolution Strategies Among the Bank and Non-bank Affiliates.** The art, and the challenge, for a credible resolution strategy is in finding the right mix and match of the available resolution strategies among the bank and non-bank affiliates. To accomplish this, an understanding of both bank insolvency and bankruptcy laws is essential. For example:
  - At what point does the publicly-listed holding company or service company enter a Chapter 11 proceeding?
  - If there is a runway period leading up to the Chapter 11 proceeding, what liquidity would be placed where among the non-bank affiliates?
  - What other assumptions should be made in any runway period?

- Does it make sense to delay the SIPA proceeding for a broker-dealer or to start it at the same time as the Chapter 11 proceeding of its holding company?
- How should cross-defaults, cross-collateral and netting be treated?
- Should asset sales be made before bankruptcy or with the blessing of the bankruptcy court?
- How should international cooperation be modeled?
- Where are shared services, technology and intellectual property located and how can their continuity be assured?

The answers to these questions will vary widely among banking institutions based on differences in business model, legal entity structure and past business and legal decisions.

- **There Will Be Impediments, and the Resolution Plan Should Propose Some Solutions.** As banking institutions are developing their resolution plans and formulating their resolution strategies, it is helpful to also develop a list of potential actions that could be taken, either by the banking institution or the regulators, in the future to address impediments to resolution. Thinking about solutions signals to the regulators that the banking institution has taken the resolution planning process seriously and anticipates issues that the regulators are likely to identify, as well as provides the banking institution an opportunity to define the solution.
- **Tailored Plans for U.S. Regional Banking Institutions.** One key way in which the plans of the large U.S. regional banking institutions will differ from those of the first wave filers is that many of the largest U.S. regional banking institutions will be able to use a tailored 165(d) plan with the result that the focus of their plans will be on the insured depository institution. We recommend that any regional bank that can, use the tailored plan. Those who are not eligible for the tailored plan should create identical insured depository and 165(d) plans.
- **Foreign Banks Should Build From Their Home Country Resolution Plan.** Many foreign banks in the second and third waves will have the benefit of having already undertaken or finished their home country resolution plans. Unfortunately, the home country resolution plan is not a substitute for the U.S. resolution plan. Many EU regulators are, for example, focusing as much on recovery planning as resolution planning while in the U.S., recovery plans are sharply separate from resolution planning. Moreover, the data and other elements required for the U.S. resolution plans often differ from those required for home country resolution plans. Once the home country plan is developed, foreign banks should meet with the U.S. regulators as soon as they can. Meeting at inception can save time on assumptions for the U.S. plan, and will ensure that any inconsistencies between U.S. and home country requirements can be flagged and addressed as early as possible. There should be tight coordination between the U.S. and global living wills project teams.
- **Tailored Plans for Foreign Banks.** Tailored plans will also work well for many foreign banks as long as their insured depository institution (if any), branches and agencies are more than 85% of total U.S. assets. We suspect that those foreign banks with a smaller U.S. footprint and with an insured depository institution will reap the most benefit from the tailoring provisions. There are tricks and traps for those with relatively large broker-dealers or with investments in other types of U.S. assets. We are hopeful that between now and next year, the U.S. regulators will refine their thinking so that foreign banks with a limited U.S. banking footprint may be able to vastly simplify their U.S. plans and work more directly from their home country plans. This cautious optimism must be tempered by the home country situation and the availability of liquidity from the head office even during a home country failure.

- **Time is Short for the Second Wave Filers.** Time is shorter than many think for the second wave filers, who should be devising their strategies and creating their data retrieval plans beginning in the fourth quarter of 2012. Our experience has been that in the design of the strategy portions, the early engagement of senior management, who have limited time to spare, is critical. Thereafter, most firms have settled on a pattern of a dedicated project management office with full-time internal personnel combined with the use of outside consultants. The requirement of board review and approval has generally led to two board meetings, an initial meeting in which the requirements are explained and the strategy is outlined and a second meeting to approve the entire plan. This implies that for second wave filers, the board should have a preview of the resolution plan by late spring 2013.
- **Many Third Wave Filers Should Wait and See.** By contrast, those banking institutions that are third wave filers could benefit from a wait-and-see approach. We believe that the vast majority of domestic U.S. banking institutions in the third wave have similar legal structures and therefore similar strategies. Moreover, there is a benefit to waiting out the regulatory learning period, especially since the path to credibility and resolution planning ought to be easier for these banking institutions. The situation is a bit more complex for foreign banks in the third wave because many of them will need to preview their U.S. resolution plans as part of their home country plans and because the availability of a tailored plan is not certain under the regulations.

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