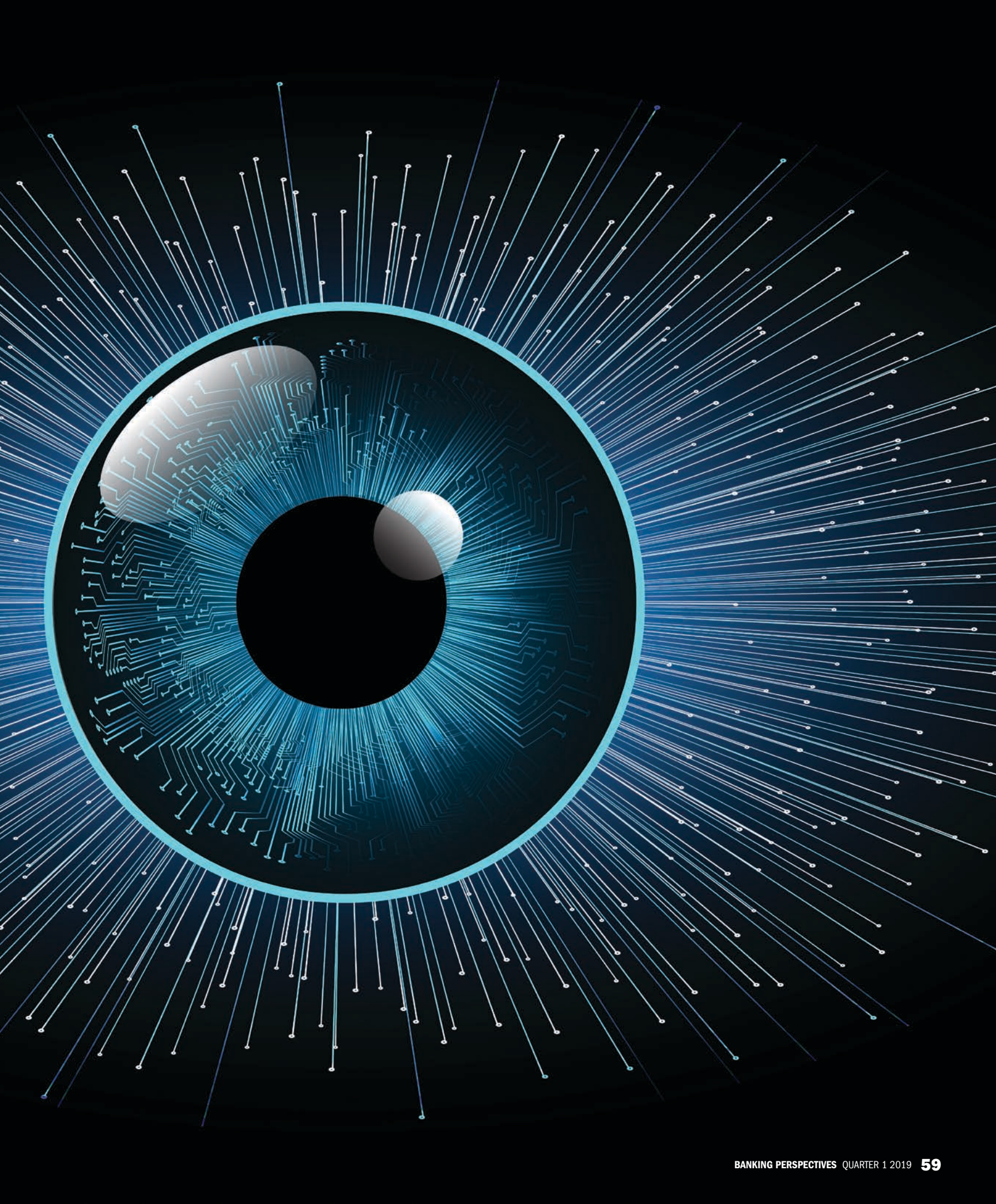


FRB AND FDIC CAST A CRITICAL EYE ON RESOLUTION PLANS

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**WHILE THE LIVING-WILL PROCESS CONTINUES TO EVOLVE,
IT IS LIKELY THAT MANY OF THE CENTRAL TENETS
AND REQUIREMENTS WILL REMAIN IN PLACE
FOR THE FORESEEABLE FUTURE.**



ON DECEMBER 20, 2018, the Federal Reserve Board (FRB) and the Federal Deposit Insurance Corporation (FDIC; together with the FRB, the Agencies) released their determinations regarding the 2018 resolution plans of four foreign banks and announced they had finalized resolution plan guidance applying to the eight U.S. global systemically important banks (G-SIBs).¹

BACKGROUND ON RESOLUTION PLANS

Resolution plans – or living wills, as they are commonly called – are a product of Section 165(d) of the Dodd-Frank Act, which was passed in the wake of the 2007–2008 U.S. financial crisis. Section 165(d) and its implementing rule² (Resolution Plan Rule) require certain financial companies to develop and submit on an annual basis the plan of each such company to resolve itself in a quick and orderly manner in the event of another financial crisis. For foreign banking organizations (FBOs), the Resolution Plan Rule is focused on ensuring the reorganization or liquidation of an FBO's U.S.-domiciled subsidiaries and operations in order to mitigate the risk that the failure of the entire company could negatively impact the U.S. financial system.

AGENCIES IDENTIFY SHORTCOMINGS IN FOREIGN BANK PLANS WHILE RECOGNIZING PROGRESS

The Agencies identified shortcomings in the 2018 plans of the four FBOs – Barclays, Credit Suisse, Deutsche Bank, and UBS – which the firms will have to address in their next resolution plan submissions, due by July 1, 2020. The Agencies stopped short of labeling the shortcomings as “deficiencies.” Importantly, the Agencies did not find that any of the plans were not credible, which would have resulted in additional prudential requirements if not corrected, including more stringent capital, leverage, or liquidity requirements and restrictions on the firm's activities, growth, and operations. The foreign firms will need to submit project plans in April 2019 describing in detail how each one intends to address the identified shortcomings in its 2020 resolution plans.

In their determination, the Agencies also acknowledged improvements in the firms' plans from their prior submissions in July 2015, including the foreign firms'

reduction of the size of their U.S. operations and adoption of a regional single-point-of-entry (SPOE) strategy, under which only a single U.S. subsidiary would enter bankruptcy proceedings. The firms' adoption of the SPOE strategy mirrors the approach taken by most major U.S. firms.

The shortcomings cited by the Agencies related to the firms' escalation triggers, which are intended to lead to increased communication and coordination between foreign and U.S. entities during times of financial stress if the triggers are breached. Under prior guidance released by the Agencies, triggers must be linked to each firm's methodology for forecasting the capital and liquidity needed to facilitate its U.S. resolution strategy. The Agencies found that, while certain of the firms utilized liquidity-based escalation triggers, none of the firms had capital-linked triggers, and one of the firms exclusively relied on management discretion. The Agencies further identified shortcomings in the model and process behind one firm's liquidity forecasting and in its mapping of shared critical services from its foreign service entities to its U.S. subsidiaries.

Quantitative triggers – thresholds based on financial targets that require the board or senior management to make decisions or take actions – continue to be an important element of recovery and resolution planning for U.S.-based regulators. The prevailing view is that management discretion is considered to be insufficient because discretion can, in the regulators' minds, lead to a slow or inadequate response to a quantitative event. Discretion does not need to be eliminated because it creates flexibility, but it must be combined with hard triggers to generate attention and activity.

The Agencies' letters suggest a larger point – growing interest in cross-border cooperation among global

regulators. Given that the financial institutions based outside of the U.S. seamlessly provide services across multiple borders, the Agencies acknowledge that the best strategy for reducing risks to the financial stability of the U.S. is the successful resolution of the global operations of a foreign firm, not simply by attempting to preserve assets for creditors in the U.S. The Agencies suggested they will proactively engage with foreign regulators and identified firms to support the joint regulatory objectives. While it's still early, it is possible that the level of expressed expectation may signal some lessening interest in ring-fencing, the holdings of bank assets at a country level. As a word of caution, however, the emerging direction of cross-border cooperation in recovery and resolution planning may wane if the current favorable economic conditions subside.

RELEVANCE TO U.S. G-SIBS

There are a few takeaways from the Agencies' findings for the U.S. G-SIBs as they prepare their 2019 resolution plans, which are due to the Agencies by July 1, 2019.

First, the findings are most instructive in showing the Agencies' continuing attention to and critical analysis of resolution plans. Since the beginning of the Trump administration, whether and in what form the living-will process will continue has been a subject of much debate. In a June 12, 2017, report, the U.S. Department of the Treasury recommended numerous reforms, including increasing the asset threshold triggering the requirement to submit resolution plans and adjusting the frequency of submission from annual to every other year.³ Congress and the Agencies have already taken steps to implement a number of those reforms, including through the Agencies' one-year extension of the U.S. G-SIBs' next filing deadline from July 1, 2018, to July 1, 2019, in September 2017.⁴ Although the Agencies have signaled that they are considering further changes to both the 165(d) plans⁵ and the separate resolution plans⁶ the FDIC requires from insured depository institutions (IDIs), the latest findings send a strong message that the Agencies continue to value the resolution-planning process for the world's largest financial institutions and to take seriously their responsibility to review and critique these plans. The regulators' learnings about the lack of communication

process and resources could be extended to U.S. internal recovery and resolution-planning management.

The specific findings for the FBOs may not be particularly relevant to the U.S. G-SIBs. The findings largely relate to concerns regarding communication between the foreign parent and U.S. subsidiaries, which are not directly applicable to financial institutions that are based in the U.S. The Agencies identified similar shortcomings and deficiencies in the U.S. G-SIBs' 2015 resolution plans related to their triggers, capital and liquidity forecasting methodology, and mapping of shared services and the financial institutions.⁷ On the other hand, U.S. firms would be prudent to continue to clearly structure and document the communication plans with their foreign operations and subsidiaries.

2019 GUIDANCE CONTINUES TO FOCUS ON PCS AND DERIVATIVES AND TRADING ACTIVITIES

The final 2019 guidance for the U.S. G-SIBs largely mirrors proposed guidance released by the Agencies in June 2018, which adapted many aspects of the Agencies' April 2016 guidance and added content regarding derivatives and trading activities and payment, clearing, and settlement (PCS) activities.⁸ The new rules continue to build on the feedback letters for the U.S. G-SIBs' 2017 resolution plan submissions, which identified four areas that required work to improve resolvability, including PCS activities.

The shortcomings cited by the Agencies related to the firms' escalation triggers, which are intended to lead to increased communication and coordination between **foreign and U.S. entities during times of financial stress if the triggers are breached.**

Other than minor modifications, the remaining guidance remains similar to that released by the Agencies in prior years. The final guidance consolidates

all prior relevant guidance, indicates that any such guidance not included has been superseded, and adds a new section outlining expected plan format and structure. The Agencies also preview in their comments preceding the guidance that they intend to address firms' capital and liquidity capabilities in future cycles.

“The emerging direction of cross-border cooperation in recovery and resolution planning may wane if the current favorable economic conditions subside.”

AGENCIES CLARIFY PCS-RELATED TERMS AND BUILD SOME FLEXIBILITY INTO PCS PLAYBOOKS

Consistent with the proposed guidance, the final guidance focuses on ensuring a firm's continued access during resolution to PCS services, which facilitate a broad range of U.S. financial transactions. The guidance requires each firm to (i) identify key clients, financial market utilities (FMUs), and agent banks using quantitative and qualitative criteria; (ii) map its material entities, critical operations, core business lines, and key clients to key FMUs and agent banks; and (iii) develop a playbook for each key FMU and agent bank reflecting the firm's role(s) as a user and/or provider of PCS services. Among other things, those playbooks – which all of the U.S. G-SIBs began developing as part of their 2017 plan submissions – must analyze the financial and operational impact to material entities and key clients in the event of adverse action by an FMU or agent bank, describe contingency arrangements, and, for PCS users, discuss PCS-related liquidity sources and uses during business-as-usual conditions and in escalating financial stress.

In response to comments the Agencies received, the final guidance adjusts the definition of certain PCS-related terms and concepts, including by clarifying the circumstances under which a firm will be considered

a user or provider of PCS services and allowing a firm to identify key clients, FMUs, and agent banks from its own perspective rather than that of the client. The Agencies' comments preceding the final guidance also provide some flexibility to firms in developing their PCS playbooks by allowing a firm to tailor playbook content to the specific relationships with its key FMUs and agent banks, clarifying that content related to the firm's role as both a user and provider of a specific PCS service may be provided in a single playbook, and endorsing the use of cross-references to other sections of the resolution plan if appropriate when discussing PCS-related liquidity capabilities.

AGENCIES INCORPORATE COMMENTS SEEKING CLARIFICATION ON DERIVATIVES CAPABILITIES

Building on prior guidance, the final 2019 guidance contains five subsections of derivatives-related expectations that are intended to mitigate the risk posed to a dealer firm's resolvability by its derivatives and trading activities. The Agencies call for development of resolution capabilities, including booking practices and interaffiliate risk monitoring and controls, that are commensurate with the size, scope, and complexity of a firm's derivatives portfolio, as well as analysis of the firm's strategy to stabilize and de-risk its derivative portfolio in a resolution scenario. As in the PCS area, the Agencies have acknowledged the significant progress dealer firms have made in this area and note that many of the expectations set forth in the guidance reflect those improvements.

The final guidance also incorporates a number of the derivatives-related comments the Agencies received. The final guidance clarifies that a dealer firm is only expected to provide information on compression strategies – a method for managing interaffiliate risk – if it anticipates relying on such strategies in resolution. Addressing the stabilization and de-risking strategy, the final guidance gives a dealer firm the choice not to model its operational costs for executing that strategy at the level of specific derivatives activities while specifying that such analyses should be more granular than the material entity level. The final guidance further clarifies certain derivatives-related terms and

expectations, including by confirming that “material derivatives entities” means a dealer firm’s material entities that engage in derivatives activities.

AGENCIES DECLINE TO INCORPORATE CERTAIN REQUESTS FROM COMMENTERS IN FINAL GUIDANCE

Although the PCS and derivatives areas of the final guidance reflect feedback from commenters, the Agencies rejected or declined to address other comments, including:

- **SPOE AS PREFERRED RESOLUTION STRATEGY.** Some commenters asked that the Agencies acknowledge SPOE – which entails the parent company sustaining its material entity subsidiaries with capital and liquidity before entering bankruptcy proceedings itself – as a credible resolution strategy and eliminate any non-SPOE-related guidance. In response, the Agencies disavowed any single preferred strategy and noted that SPOE remains untested and has inherent challenges and difficulties.
- **RECONSIDERATION OF PREPOSITIONING REQUIREMENTS.** Other commenters asked that the Agencies reconsider requiring local prepositioning of capital and liquidity at material entities given firms’ adoption of secured support agreements. Secured support agreements, the commenters asserted, eliminate the need for prepositioning by ensuring the availability of resources in financial stress and providing for their distribution according to each entity’s specific needs. The Agencies indicated that while they continue to consider the benefits and drawbacks of secured support agreements, they do not view these agreements as a substitute for local prepositioning.
- **REFORMS TO IDI AND 165(D) PLAN PROCESS.** The Agencies also left calls for elimination of the IDI plan requirement for firms that have adopted SPOE and formalization of an every-

other-year submission requirement for 165(d) plans to future proposed rulemaking.

Overall, the final guidance reinforces the theme shown in the Agencies’ FBO plan determinations that while the living-will process continues to evolve, it is likely here to stay, notwithstanding elections and administration changes, and many of the central tenets and requirements will remain in place for the foreseeable future. ■

“Consistent with the proposed guidance, **the final guidance focuses on ensuring a firm’s continued access during resolution to PCS services**, which facilitate a broad range of U.S. financial transactions.”

ENDNOTES

- 1 “Federal Reserve and FDIC Announce Resolution Plan Determinations for Four Foreign-Based Banks and Finalize Guidance for Eight Domestic Banks,” press release, December 20, 2018. <https://www.federalreserve.gov/newsevents/pressreleases/bcreg20181220c.htm>
- 2 Electronic Code of Federal Regulation. https://www.ecfr.gov/cgi-bin/retrieveECFR?gp=&SID=745f36bbc567b55fbc-7525379a8bb3d6&r=PART&n=12y4.0.1.1.13#se12.4.243_16
- 3 “A Financial System That Creates Economic Opportunities: Banks and Credit Unions,” U.S. Department of the Treasury, June 2017. <https://www.treasury.gov/press-center/press-releases/Documents/A%20Financial%20System.pdf>
- 4 “Agencies Extend Next Resolution Plan Filing Deadline for Certain Domestic and Foreign Banks,” press release, September 28, 2017. <https://www.federalreserve.gov/newsevents/pressreleases/bcreg20170928a.htm>
- 5 “Agencies Announce Joint Determinations for Living Wills,” press release, December 19, 2017. <https://www.federalreserve.gov/newsevents/pressreleases/bcreg20171219a.htm>
- 6 “Keynote Remarks by Jelena McWilliams, Chairman, Federal Deposit Insurance Corporation, to the 2018 Annual Conference of The Clearing House (TCH) and Bank Policy Institute (BPI),” November 28, 2018. <https://www.fdic.gov/news/news/speeches/spnov2818.pdf>
- 7 “Agencies Announce Determinations and Provide Feedback on Resolution Plans of Eight Systemically Important, Domestic Banking Institutions,” press release, April 13, 2016. <https://www.federalreserve.gov/newsevents/pressreleases/bcreg20160413a.htm>
- 8 Final guidance from the Board of Directors of the Federal Reserve Board. <https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20181220c5.pdf>