ALERT MEMORANDUM

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First Wave FBOs Receive Feedback: Significant Progress, Next Steps Identified

On December 20th, the Federal Reserve and the FDIC (the "Agencies") provided feedback on the July 2018 resolution plans filed by four foreign banking organizations – Barclays PLC, Credit Suisse Group AG, Deutsche Bank AG and UBS Group AG (collectively, the "First Wave FBOs"). The feedback letters noted meaningful improvements over the resolution plans filed by the First Wave FBOs in 2015 to enhance resolvability and facilitate orderly resolution in bankruptcy. However, the Agencies did identify specific "shortcomings" that the First Wave FBOs must address in their next resolution plans due on July 1, 2020. Detailed project plans to remedy these shortcomings, and to complete other enhancements, must be filed by April 5, 2019.

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The feedback letters reflect a growing recognition of the importance of coordinating the First Wave FBOs' home country strategies with their U.S. resolution plans. This could be a significant development if the Agencies begin to look at the U.S. resolution plans through the lens of those strategies. However, the feedback letters focus principally on U.S.-specific resolvability. In particular, the feedback letters focus on identified "shortcomings" and specific "enhancement initiatives" to improve assessment of capital and liquidity needs in resolution and to better define triggers for deployment of needed capital and liquidity to the companies' operating subsidiaries. In addition, the feedback letters continue to focus on payments, clearing and settlement ("PCS") activities; derivatives booking practices; and legal entity rationalization. All of these issues parallel many of the points of emphasis contained in the Agencies' final guidance to the eight U.S. global systemically important banks ("G-SIBs"), also released on December 20th. We discuss the U.S. G-SIB guidance in a separate Alert Memorandum.

Key Takeaways:

— *Overview*.

- While the Agencies did identify specific "shortcomings", they did not identify any "deficiencies" (which potentially could require prompt remediation to avoid restrictions on activities, growth and operations). In assessing the progress towards resolvability, the Agencies noted that each First Wave FBO had significantly downsized its U.S. operations; put in place intermediate holding companies; and developed loss-absorbing capacity, shared service resiliency and much greater operational capabilities.
- The Agencies' recognition of the key role played by the home country strategies in limiting risk from U.S. operations to the U.S. financial system is both potentially important for the future and limited by the narrow, U.S. focus of the U.S. resolution plans. For each of the First Wave FBOs, the home country strategy is a single point of entry strategy where the parent company is recapitalized through conversion of total loss absorbing capacity. Significantly, the Agencies recognize that the "preferred outcome" is to apply this strategy to achieve "a successful home country resolution that prevents risks to financial stability" in the United States. More importantly, the Agencies describe their intent to proactively coordinate with the First Wave FBOs and their home country regulators on key issues, including legal entity rationalization, PCS activities and derivatives booking issues. The First Wave FBOs have long pointed out that the Agencies must play a critical role in improving coordination, so this new emphasis on the Agencies' need to do so is welcome.
- However, the feedback letters focus on implementing the U.S. resolution strategies, which are built around single point of entry strategies based on the FBOs' intermediate holding companies. While emphasizing the home country strategies and the separate U.S. resolution planning strategy may appear inconsistent, the Agencies appear to view the U.S. framework as designed to improve coordination with the foreign parents and their home country regulators.
- A common focus across the feedback letters is the necessity for enhancements in the governance mechanisms related to the transfer of capital and liquidity support to operating subsidiaries from the companies' intermediate holding companies. The Agencies note the importance of enhancements both in analytical capabilities and in defining trigger mechanisms for deployment of support.
- The Agencies also recognize that alternatives to secured contractually binding mechanisms for providing support to operating subsidiaries of an intermediate holding company may be available. Both Credit Suisse and UBS used support agreements reliant on the Bankruptcy Code safe harbors for qualified financial contracts. In their letters, the Agencies note this alternative and anticipate that further discussions on policy and implementation issues may be necessary.
- The feedback letters also confirm the Agencies' intention to provide further clarifying guidance to the First Wave FBOs during 2019. Presumably, and hopefully, this will be done through a public notice

and comment process similar to that used for the December 20, 2018 U.S. G-SIB final guidance. Of course, it will be critical for this process to produce final guidance with sufficient time for implementation by the July 1, 2020 due date.

— *Regulatory Focus*. The Agencies emphasize six specific key elements in their feedback letters to the First Wave FBOs:

- Interaction of U.S. resolution planning with home country resolution authorities;
- Current status of U.S. operations;
- Changes in the U.S. resolution strategy and actions taken to enhance resolvability;
- Shortcomings;
- Home and host cooperation; and
- Remaining projects.

As noted above, the Agencies recognized considerable progress by all First Wave FBOs in improving resolvability, including actions taken by the First Wave FBOs to comply with resolution-related rules regarding holding companies, stays of qualified financial contracts and total loss-absorbing capacity.

With respect to home and host cooperation, the feedback letters include guidance on legal entity rationalization, PCS activities and derivatives booking practices. These three areas parallel the sections that are the principal focus of changes from the prior 2016 U.S. G-SIB resolution planning guidance and the proposed and final guidance to the U.S. G-SIBs also published on December 20, 2018. The feedback letters emphasize that the strategies of each First Wave FBO for addressing these three areas should align with a continuity strategy developed at the group level that considers the objectives of the firm's group-wide single-point-of-entry resolution strategy. The Agencies also noted that they intend to coordinate with home country authorities to help ensure a firm's resources will be positioned appropriately at the time of resolution.

— *Assessment of Shortcomings*. Based upon their review, the Agencies note the following shortcomings in the 2018 resolution plans:

- The Agencies identify shortcomings for each of the First Wave FBOs in the governance mechanisms designed to trigger escalating actions and communications during stress. While there was some variation in the issues identified for each company, the Agencies are requiring all First Wave FBOs to more closely tie the triggers to methodologies for forecasting the capital (and for UBS also liquidity) needs to support their resolution strategies. In particular, the triggers for each First Wave FBO must explicitly take into account management's forecasts of losses and other balance sheet changes that would occur in the resolution period.
- *Additional Shortcomings*: The Agencies identify two additional shortcomings in the 2018 plan of Credit Suisse. The first simply requires Credit Suisse to demonstrate an RLEN framework that is tested, controlled and repeatable to provide better assurance that the cash flow forecasting during a crisis will be reliable.[1]

[1] Prior guidance included certain requirements for estimating liquidity requirements under the moniker of "Resolution Liquidity Execution Need".

The second requires Credit Suisse to provide more detail about its mapping of certain shared services provided by specific foreign service entities to support U.S. operations.

— *Interim Enhancement Initiatives.* The Agencies require all four First Wave FBOs to complete implementation of ongoing enhancements of the resolvability of their U.S. operations prior to July 1, 2020. To this end, the FBOs must develop and submit to the Agencies by April 5, 2019, detailed plans regarding the completion of any ongoing or future enhancement initiatives identified in the 2018 plan or during the 2018 plan review.

— *Qualified Financial Contract Support Structure*. As stated above, the Agencies also note that Credit Suisse and UBS developed a support agreement structure involving a contingent capital share purchase agreement between their top tier U.S. holding companies and their respective subsidiaries. The Agencies:

- Explicitly recognize that this structure is designed to utilize one or more of the safe harbors provided in the U.S. Bankruptcy Code for qualified financial contracts.
- Implicitly acknowledge the flexibility of the contingent capital share purchase agreements.
- Note that the policy implications of contingent capital share purchase agreements will be considered further by the Agencies, and they will engage directly with Credit Suisse and UBS.
- In the December 20th U.S. G-SIB guidance, the Agencies similarly note that they continue to consider the merits and limitations of secured support agreements. In that guidance, the Agencies decline to endorse specific structures noting that the secured support agreements are untested and the availability of sufficient contributable resources may be unclear. In short, the final components of support agreements remain under consideration.

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