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ALERT MEMORANDUM

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Federal Reserve and FDIC Require First Wave Filers to Show "Significant Progress" on Specific Shortcomings for 2015 Resolution Plans

On August 5, 2014, the Board of Governors of the Federal Reserve System and the Federal Deposit Insurance Corporation (the "Agencies") released a Joint Statement identifying common shortcomings and action steps for the 11 largest financial companies that initially filed resolution plans in 2012 (the "First Wave Filers").[1] Contemporaneously with the Joint Statement, the Agencies sent letters to each of the First Wave Filers in which they identified more detailed and specific shortcomings in individual First Wave Filers' 2013 resolution plans and additional information required for the 2015 plans (the "Joint Letters").

In effect, the Joint Statement and the Joint Letters represent the first company-specific feedback provided to the First Wave Filers since they filed their initial resolution plans in 2012. The absence of any meaningful feedback through the filing of three resolution plans had significantly impaired accomplishment of the goals of the resolution planning process, which was designed to be an engagement between the Agencies and the filing companies to achieve progressive improvement in the companies' resolvability. In an odd contrast, companies filing resolution plans in the second wave and some in the third wave received more guidance in the form of specific questions and follow-up meetings than most of the First Wave Filers.[2] The practical effect of the Joint Statement was to provide the first opportunity for a dialogue—which the Joint Statement committed the Agencies to initiate—between the First Wave Filers and the Agencies based on company-specific feedback.

The Joint Statement received considerable media attention, in large part because the FDIC's Board of Directors determined "that the plans submitted by the first-wave filers are not credible and do not facilitate an orderly resolution under the U.S. Bankruptcy Code."[3] In contrast, the Federal Reserve did not make a finding that the plans were "not credible." Although the FDIC's finding that the 2013 plans were "not credible" received the bulk of the media attention, this determination has no legal effect because the specific provisions of 12 C.F.R. Parts 243 and 381 (the "SIFI Rule") require a joint finding by the Agencies before

1 The joint statement is available at http://www.federalreserve.gov/newsevents/press/bcreg/20140805a.htm (the "Joint Statement"). The First-Wave Filers are Bank of America, Bank of New York Mellon, Barclays, Citigroup, Credit Suisse, Deutsche Bank, Goldman Sachs, JPMorgan Chase, Morgan Stanley, State Street Corp. and UBS.

2 In addition to the First Wave Filers, bank holding companies and foreign banking organizations that have $50 billion or more in total consolidated assets and financial companies designated by the Financial Stability Oversight Council are required to file resolution plans. 12 C.F.R. §§ 243.3(a) and 381.3(a).

3 Joint Statement.

action is required under the SIFI Rule. In effect, the Joint Statement—as well as the FDIC's finding—simply represents a strong message from both Agencies that the First Wave Filers must take "immediate action to improve resolvability" and make "significant progress to address all the shortcomings" in their 2015 resolution plans. If the First Wave Filers do not do so, the Agencies stated that they "expect to use their authority" to find that the plans do "not meet the requirements of the Dodd-Frank Act."

In addition to the Joint Statement, the Federal Reserve issued a separate statement that recognized improvements in the plans, acknowledged the lack of prior guidance on the 2013 plans, and cited the Agencies' prior statements that initial resolution plans were not expected to be found deficient and would form the basis for developing more robust plans during subsequent years. Nevertheless, the statement emphasized that the identified shortcomings must be addressed in the 2015 resolution plans.[4]

The FDIC's separate resolution plan rule for insured depository institutions ("IDIs") allows the FDIC to make a credibility determination with respect to IDI plans (which are filed concurrently with a filer's SIFI Rule plan).[5] The FDIC has not yet done so. Neither the SIFI Rule nor the FDIC's IDI rule "require" the Agencies to make a determination about whether a plan is credible or not. A determination that a resolution plan is "not credible" is at the discretion of the Agencies, or of the FDIC in the case of the IDI plans. To date, the FDIC has not provided any indication regarding whether it will make a credibility determination on the First Wave Filers' IDI plans.

<u>Key Takeaways</u>

- The First Wave Filers have been directed to demonstrate significant progress in addressing specific shortcomings identified in each Joint Letter by July 1, 2015. After July 1, 2015, the Agencies will reassess each resolution plan.

- The Joint Statement identified two broad common shortcomings in the plans: "(i) assumptions that the agencies regard as unrealistic or inadequately supported, such as assumptions about the likely behavior of customers, counterparties, investors, central clearing facilities, and regulators, and (ii) the failure to make, or even to identify, the kinds of changes in firm structure and practices that would be necessary to enhance the prospects for orderly resolution." In its separate statement, the Federal Reserve similarly identified the "use of optimistic and unrealistic assumptions about the ability of the firm to avoid the consequences of bankruptcy, reliance on unsupported expectations regarding the international resolution process, and failures to address structural and organizational impediments to an orderly resolution of the firm in bankruptcy."

4 Statement of the Board of Governors of the Federal Reserve System regarding the 2013 resolution plans filed by 11 large banking organizations (Aug. 5, 2014), available at http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20140805-statement.htm.

5 12 C.F.R. Part 360.

- To address these common shortcomings, the Agencies identified certain broad actions that First Wave Filers should consider to improve their resolvability:
    - o establishing a rational and less complex legal structure that would take into account the best alignment of legal entities and business lines to improve the firm's resolvability;
    - o developing a holding company structure that supports resolvability;
    - o amending, on an industry-wide and firm-specific basis, financial contracts to provide for a stay of certain early termination rights of external counterparties triggered by insolvency proceedings;
    - o ensuring the continuity of shared services that support critical operations and core business lines throughout the resolution process; and
    - o demonstrating operational capabilities for resolution preparedness, such as the ability to produce reliable information in a timely manner.[6]
- These actions, and the identified specific shortcomings and required responses detailed in the individual Joint Letters, will require a very significant amount of additional work by the First Wave Filers. In addition to the specific shortcomings identified and the responsive actions required, the 2015 resolution plans must include additional information and meet stringently defined, and more conservative, assumptions. In short, the Agencies have set challenging requirements for the First Wave Filers' 2015 plans that will require difficult choices in preparing action plans to demonstrate the requisite "significant progress to address all the shortcomings identified in the letters." However, it is significant that the regulators did not require the First Wave Filers to completely resolve the shortcomings by the time the 2015 plans are filed. The requisite "significant progress" should imply appropriate, progressive steps that may take some reasonable period of time to fully implement.
- It is unclear how the Agencies, when evaluating 2015 plans, will take into account industry-wide obstacles that cannot be mitigated by individual filers. The initiative to address certain early termination rights under ISDA Master Agreements that arise in the context of the failure or resolution of a financial company may create a model for how the industry as a whole can address certain regulatory concerns going forward. There, the International Swaps and Derivatives Association, an industry association, is working with regulators in major financial markets on behalf of both dealer-banks and other derivatives users to develop contractual approaches to address an obstacle common to

[6] This requirement to demonstrate certain operational capabilities is echoed in Supervisory Letter SR 14-1, issued by the Federal Reserve on January 24, 2014, "Heightened Supervisory Expectations for Recovery and Resolution Preparedness for Certain Large Bank Holding Companies – Supplemental Guidance on Consolidated Supervision Framework for Large Financial Institutions" (available at http://www.federalreserve.gov/bankinforeg/srletters/SR1401.htm), which is applicable to a majority of the First-Wave Filers.

many. However, this model may not be applicable to challenges related to cross-border cooperation, where action is required primarily by government actors (e.g., regulators, legislatures).

- The statements by the Agencies clearly indicate substantive and procedural disagreements, and reflect a different assessment of the consequences that should apply to the First Wave Filers as a result of the Agencies' evaluation of their 2013 plans. This may have been influenced by different assessments of the propriety of making a "not credible" determination without having previously provided substantive and company-specific feedback and an opportunity to respond and correct the identified shortcomings. In fact, the separate statements by the FDIC Chairman, Vice Chairman, and Director Norton also reflect different approaches to the message being conveyed.[7]

- The Joint Statement stopped short of stating that plans would necessarily be deemed not credible by both Agencies if the shortcomings are not fully addressed, but the Federal Reserve noted in its separate statement that, if a company failed to "satisfactorily address" the shortcomings, the Federal Reserve "expects to find the resolution plan to be deficient." As in the Joint Statement, the Federal Reserve pointedly refused to state whether that would necessarily be a decision that the plan was "not credible." However, the clear message was that specific improvements addressing the shortcomings identified in the Joint Letters must be made to avoid the risk that both Agencies may determine a plan to be "not credible."

  If the Agencies jointly determine that one or more of the resolution plans filed is "not credible" that finding triggers specific regulatory steps. Once a determination of "not credible" is made, the company is required to resubmit its plan within 90 days, or a longer or shorter time as designated by the Agencies, to address the deficiencies identified by the Agencies. If the company fails to submit a plan within the required time or the Agencies determine that the resubmitted plan does not adequately address the deficiencies, the Agencies may impose additional capital, leverage or liquidity requirements on, or restrict the growth, activities or operations of, a covered company or its subsidiaries. If the company fails to submit a plan within two years of the decision to impose these additional requirements and/or restrictions that adequately addresses the deficiencies, the Agencies may jointly require the company to divest assets or operations as necessary to facilitate orderly resolution.[8]

[7] Statement by Martin J. Gruenberg, Chairman, FDIC on the Issuance of Joint Letters to the First-Wave Resolution Plan Filers (Aug. 5, 2014), available at https://www.fdic.gov/news/news/speeches/spaug0514.html; Statement by Thomas M. Hoenig, Vice Chairman, FDIC on the Credibility of the 2013 Living Wills Submitted by First Wave Filers (the "Hoenig Statement") (Aug. 5, 2014) available at http://www.fdic.gov/news/news/speeches/spaug0514a.html; Statement of Jeremiah O. Norton on Memorandum and Resolution re: Determination Regarding 2013 Resolution Plans of Eleven First Wave Covered Companies and Memorandum and Resolution re: Authorization to Send Letters Jointly with Board of Governors of the Federal Reserve System in Response to October 2013 Resolution Plan Submissions of First Wave Covered Companies (Aug. 5, 2014) available at https://www.fdic.gov/news/news/speeches/spaug0514b.html.

[8] 12 C.F.R. §§ 243.6 and 381.6.

- FDIC Vice Chairman Thomas M. Hoenig provided the most negative view of the First Wave Filers' 2013 resolution plans. He concluded that the "plans provide no credible or clear path through bankruptcy that doesn't require unrealistic assumptions and direct or indirect public support." In addition, he took issue with the suggestion that filers had received inadequate prior feedback from the Agencies. He noted, "I also am sometimes told that regulators have not provided sufficient guidance to firms preparing plans. I disagree and would note that besides regulators, the bankruptcy law itself provides guidance."[9]

- The Joint Statement did not comment on the 2014 plans filed in July. Although the Agencies noted "some improvements" in the 2013 plans from the initial 2012 plans, the Joint Statement focused on "specific shortcomings" identified in those plans. Since the 2014 plans were filed without the guidance provided in the Joint Letters, it is likely that the principal focus for evaluation will be the 2015 resolution plans, and that further guidance on the 2014 plans is unlikely.

- The Joint Statement also noted that the Agencies are "committed to finding an appropriate balance between transparency and confidentiality of proprietary and supervisory information in the resolution plans" and that "the agencies will be working with these firms to explore ways to enhance public transparency of future plan submissions." It remains to be seen how this goal will be achieved, but it is unlikely that the Agencies would back away from their prior strong assertions that the confidential portions of the plans are protected from disclosure under the Freedom of Information Act as confidential supervisory information. It is more likely that this goal will be pursued through greater transparency regarding steps being taken to improve resolvability and possibly by requiring filers to include more information in the public sections of their plans.

- By its terms, the Joint Statement does not apply to the resolution plans of second and third wave filers. The focus in the Joint Statement and the Federal Reserve's separate statement is on whether or not the resolution plans of the First Wave Filers could be implemented effectively under the U.S. Bankruptcy Code (or other applicable insolvency frameworks) without creating systemic consequences for the U.S. financial system. As a result, it can be expected that these concerns would be substantially less for second and third wave filers, and particularly those with few or no critical operations.[10] Nonetheless, some areas of emphasis identified in the Joint Statement clearly mirror those identified in the April 2013 guidance that has now been applied to second wave filers. It is clear that the Agencies focused on (i) the validity of the assumptions and supporting analyses; (ii) the continuity of shared services; and (iii) operational capabilities to provide needed information to resolution authorities if a filer fails. It can be expected that these areas will continue to be emphasized for all filing companies.

9 Hoenig Statement.

10 "Critical operations" are potentially systemically important businesses or operations of a filer. The SIFI Rule defines "critical operations" to mean the operations of the filer "the failure or discontinuance of which, in the view of the covered company or as jointly directed by the [Federal Reserve] and the [FDIC], would pose a threat to the financial stability of the United States."

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