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ALERT MEMORANDUM

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Key Takeaways from FDIC Guidance for Bank Resolution Plans

Overview

On December 17, 2014, the Federal Deposit Insurance Corporation ("FDIC") released its most detailed guidance to date on resolution plan requirements for insured depository institutions with $50 billion or more in total assets (the "Guidance").[1] The Guidance defines the goal quite succinctly as development of a resolution plan that "should enable the FDIC, as receiver, to resolve the CIDI in the event of its *insolvency* under the FDI Act" (italics in original). As a result, the Guidance effectively seeks a resolution plan that could be implemented in practice much like the internal "strategic resolution plans" used by the FDIC to plan for a bank receivership. The Guidance seeks to accomplish this by mandating a much greater level of detailed analytical support for assumptions, scenarios, strategies, and related operational details than has been required previously.

The Guidance builds on previous FDIC guidance for CIDI resolution plans, the August 2014 and April 2013 guidance provided jointly by the FDIC and Federal Reserve to financial companies for 165(d) Plans, as well as many of the questions posed to individual CIDIs over the past year.[2] Nonetheless, the new Guidance imposes additional, specific requirements for the assumptions, scenarios, strategies, and supporting analyses that must be used in the CIDI resolution plans. There is a risk that these very prescriptive and detailed requirements could undercut the recent emphasis on concise narratives of the resolution strategies. There is no question that the Guidance will increase the cost and complications of preparing CIDI resolution plans. The FDIC's press release announcing the Guidance notes that it will apply to plans filed in 2015.

In reviewing the Guidance, it is important to remember that, while the requirements of the CIDI Rule and the SIFI Rule significantly overlap, the rules serve different goals. The CIDI Rule and the Guidance focus on assisting the FDIC in developing an executable resolution plan under the Federal Deposit Insurance Act ("FDI Act") that meets the requirement that any resolution of an

[1] The Guidance is available at https://www.fdic.gov/news/news/press/2014/pr14109.html. Insured banks with $50 billion or more in total assets are defined as covered insured depository institutions ("CIDIs") and must submit resolution plans to the FDIC at least annually under the FDIC's resolution planning regulation, 12 C.F.R. Part 360.10 ("CIDI Rule"). This regulation is separate from the joint FDIC and Board of Governors of the Federal Reserve System ("Federal Reserve") regulations applicable to potentially systemically important financial institutions supervised by the Federal Reserve with $50 billion or more in total consolidated assets ("SIFI Rule") requiring resolution plans under Section 165(d) of the Dodd-Frank Wall Street Reform and Recovery Act ("SIFI Plans").

[2] See, e.g., the following Clearly Gottlieb Alert Memoranda available at www.cgsh.com: Federal Reserve and FDIC Provide Guidance for Third Wave Filers on 2014 Resolution Plans (August 18, 2014); Federal Reserve and FDIC Require First Wave Filers to Show "Significant Progress" on Specific Shortcomings for 2015 Resolution Plans (August 11, 2014); Key Takeaways from Guidance to First-Round Filers on 2013 Resolution Plan Submissions (April 23, 2013); The Next Generation of U.S. Resolution Plans: Increased Prominence of Resolution Strategies for FDIC-Insured Depository Institutions (August 6, 2012); A Non-U.S. Bank's Guide to U.S. Resolution Plans (October 18, 2011).

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insured bank must be the "least costly" of all possible methods to the FDIC's Deposit Insurance Fund.[3] This means that there is a great focus on the least cost analysis, protection of insured depositors, and the resolution details that could allow the FDIC to implement the plan for a particular CIDI. In contrast, the SIFI Rule focuses on a "rapid and orderly resolution" under the Bankruptcy Code that mitigates the risk of serious adverse effects on U.S. financial stability. While the SIFI Rule similarly focuses on the practicality of the resolution plans, the Federal Reserve in particular considers the SIFI Plans as part of its supervisory strategy for these companies. This highlights two further distinctions. Only the FDIC evaluates the CIDI Plans, while both the FDIC and Federal Reserve review the SIFI Plans. While the SIFI Rule lays out a process for remediation and potential consequences if the SIFI Plan is "not credible", the CIDI Rule is silent on the consequences likely because the FDIC would have to coordinate with the primary supervisor in taking any action to require remediation. Finally, the FDIC's Guidance applies to the 36 CIDIs, while the SIFI Rule applies to the larger number of bank holding companies and nonbank financial companies supervised by the Federal Reserve who also conduct a wider variety of financial businesses directly and through their subsidiaries. This broader application inherently creates additional complications when those businesses are subject to different insolvency frameworks both within the U.S. and abroad.

Key Takeaways

- Emphasis on Realistic Assumptions and Justifications. The Guidance, like the August 2014 guidance to First Wave filers, emphasizes that CIDIs should avoid "unsubstantiated or simplifying assumptions" and should support all assumptions with explanations and analyses based on "well-founded legal, industry, market and/or historical justifications."[4] In addition to the standard assumptions required by the CIDI Rule, as well as past FDIC instructions, the Guidance focuses on assumptions that could affect the cost of the CIDI resolution given the FDIC's attention to identifying the "least costly" resolution strategy. For example, the Guidance requires filers using a bridge bank strategy to justify why it may be least costly to transfer all deposits, rather than only insured deposits, to the bridge bank. In line with other recent instructions, the Guidance notes that a CIDI should not assume any additional unsecured funding "immediately prior to failure." Additionally, the Guidance provides a list of items that all CIDIs should include in their resolution plans, including consistency with the FDIC's legal authority and an assumption that the markets are functioning and that competitors may be in a position to take on business.

- Focus on Specific Runway and Failure Scenarios. The Guidance initially addresses the need for more detailed descriptions and, in the FDIC's view, more realistic failure scenarios. For example, the FDIC emphasizes that the financial condition of the CIDI when the FDIC is hypothetically appointed as receiver should reflect "an insolvency-based" ground for appointment with assets less than obligations to creditors. While

[3] 12 U.S.C. 1823(c)(4)(A).
[4] The "First Wave" filers include those financial companies who initially filed their resolution plans in 2012 and include the companies with total consolidated assets of $250 billion or more in total nonbank assets or, for a foreign-based company, in total U.S. nonbank assets. 12 C.F.R. Part 381.3(a)(1) and Part 243(a)(1).

many plans in the past have relied on unspecified idiosyncratic events as the cause of failure, the FDIC states that this is “not acceptable.”

- In modeling the failure scenario, CIDIs are expected to specify and reflect a material impairment or loss in one or more Core Business Lines. The path-to-failure model should also be described in detail.

- The FDIC also notes that CIDIs should frame the failure scenario by taking into account the bank’s current structure and operating model as well as historical facts. The Guidance states, as an example, that greater than 99% of bank failures result in some loss to the FDIC’s Deposit Insurance Fund. While many resolution plans in the past have sought to demonstrate that the CIDI could be resolved at no cost to the FDIC, it is clear that the FDIC will look at such conclusions skeptically and require additional analysis in support.

- While the April 2013 guidance to First Wave filers for SIFI Plans stated that a runway “should” be used, the Guidance simply says that a runway of not more than 30 days prior to appointment of the FDIC as receiver “may” be used. The Guidance sets forth a list of issues that should, at a minimum, be addressed in a runway including CIDI actions that could be taken to sell or spin off assets (though, as the Guidance recognizes, this is unlikely), effects of the runway on liquidity, the order of potential failures of material entities, and actions that could ensure depositors receive access to their insured deposits. In common with the overall emphasis on additional details and analysis to support the resolution plan, the Guidance requires justifications for the length of the runway and its reasonableness given the economic scenarios and the business of the particular CIDI.

- Resolution Strategies. The Guidance is particularly prescriptive regarding the types of resolution strategies that must be included in the CIDI Plan as well as in their specific components, supporting cost analyses, preparation of balance sheets, and evaluations of potential acquirers. These specific elements will require a substantially greater commitment of resources by many CIDIs given the detailed supporting estimates, legal and financial analyses, and justifications for assumptions and conclusions that are required. While the CIDI Rule does require CIDIs to address these issues, the much greater level of detail now specified in the Guidance creates anew the risk that CIDI resolution plans will become a series of hypothetical analyses rather than remaining focused on improving approaches to applying the FDIC’s demonstrably effective resolution strategies to CIDIs of different sizes and complexities. The additional complexity required by the Guidance could impair the coherence of the resulting resolution strategies and undercut the focus, recently emphasized both by the FDIC and the Federal Reserve, on a concise narrative of the resolution strategies.

  Among the requirements for resolution strategies are the following:

  - In developing a range of resolution strategies, a CIDI resolution plan should include at least one “Multiple Acquirer Strategy” and one “Liquidation Strategy.”

A Multiple Acquirer Strategy involves the division of a CIDI's business lines and their sale to multiple acquirers; a Liquidation Strategy involves liquidation of the firm, including a payout of insured deposits.

- Multiple Acquirer Strategies are expected to include the use of one or more bridge banks, including pro forma balance sheets evidencing key transactions during operations of the bridge bank and at the time of exit.

  - At least one Multiple Acquirer Strategy should involve the recapitalization of a portion of the CIDI through a single or multiple IPO transactions. The Guidance specifically requires the IPO transaction(s) to encompass from 25 to 50 percent of the CIDI's assets at the time of failure – presumably to require the restructuring of the CIDI and sale or other disposition of a substantial proportion of its operations. This requirement may indicate that the FDIC wishes CIDIs to consider how their operations could be downsized as part of the IPO process, both to evaluate ways to limit further industry consolidation and to introduce additional complexities into the planning process.

  - Given the diversity in the sizes and complexities of the 36 CIDIs filing plans, and the likely effectiveness of the FDIC's normal strategies of purchase and assumption transactions and bridge banks in resolving many of those banks, it is reasonable to question whether one or multiple IPO transactions would be necessary to achieve a "least costly" resolution. While the FDIC may be concerned about the potential for additional banking concentration from the normal strategies, and the IPO approach mirrors aspects of the preferred "single point of entry" strategy under Title II of the Dodd-Frank Act, the FDIC should consider whether this new IPO requirement is appropriate for all CIDIs.

- The Guidance provides a detailed laundry list of issues that should be addressed in a "fully developed strategy." These include potential impediments to the strategy, such as the legal or organizational structure of the company and its operational capabilities as well as the difficulties in separating business lines and the size of the potential acquirers. This latter issue specifically requires consideration of the likelihood that transactions with some potential acquirers might breach deposit or concentration caps and receive heightened regulatory scrutiny. The Guidance also requires a discussion of the specific actions, including marketing, needed to implement a transaction and the time required to accomplish them; which assets and liabilities will be sold or retained in the receivership or bridge bank, and the process the bank uses to value business lines, asset portfolios, and the key drivers of value; how services will be maintained during the resolution; whether any purchase and assumption transaction is "All Deposit' or "Insured Deposit Only" and why. For recapitalization transactions, the Guidance requires a description of how the CIDI would determine how much new capital is needed as well as the sources and types of capital. This is a particularly challenging requirement given the

complexities of the international dialogue around recapitalization transactions, as shown by the recent FSB consultation on "Total Loss Absorbing Capacity." The FDIC also requires a further analysis of potential acquirers, including a listing and discussion of why the acquisition would be attractive to the acquirer.

  - The Guidance also provides a list of items that should be included in a fully developed resolution strategy that utilizes a bridge bank. Among other things, the FDIC expects resolution plans to include a description or discussion of assets, liabilities, and material contracts to be transferred to the bridge or left behind in receivership; whether insured and uninsured deposit liabilities are transferred to the bridge bank; the operational complexities of the CIDI's large specialized business lines; the types of liquidity sources and amounts required to operate the bridge; how continuous access to IT, financial market utilities, and key employees will be ensured; and the impact on deposits and franchise value if the bridge is in operation for an extended period of time. The detail specified in these analyses effectively requires CIDIs to prepare and defend an operational profile and business plan for the bridge bank.

- Least Cost Analysis. The Guidance effectively requires CIDIs to "prove up" a detailed least cost analysis to support their proposed resolution strategies. Among the issues that the Guidance indicates should be considered are the estimated cost of liquidation; the premium expected from the use of a bridge bank over a direct sale; the estimated market value of business lines, subsidiaries, or assets to be sold; the estimated marginal cost of operating a bridge bank; and the priority of claims to the receivership. The Guidance specifically requires a cost analysis for each strategy and a comparative analysis across the strategies, including as a comparative baseline a liquidation strategy. This reflects the ordinal ranking nature of the FDIC's internal least cost analysis. However, the specificity of the Guidance's requirements for the supporting considerations will impose significant new costs and analytical hurdles for CIDIs given their understandable lack of experience in conducting such least cost analyses under the FDI Act.

- Obstacles that Must be Addressed. The FDIC has set forth five significant obstacles to resolution that CIDIs should address in their resolution plans. These five obstacles have ben points of emphasis for the FDIC and Federal Reserve since early 2013. The Guidance specifies that the CIDI should describe the relationship of each obstacle to its resolution strategies and discuss the actions or steps it has taken or proposes to take to remediate or otherwise mitigate each obstacle. The Guidance places a particular emphasis on the development of fully developed project plans to address necessary improvements in response to the obstacles. The project plans should include detailed initiation dates, budgets, milestones and target completion dates need to be included. The FDIC provides illustrations of potential project plans for employee retention programs, improved transitional services agreements and service level agreements, continuity of access to FMUs, and enhanced communications strategies.

  The five obstacles are:

  - Multiple competing insolvency proceedings (under different U.S. insolvency regimes or in different jurisdictions);
  - A potential lack of global cooperation among resolution authorities;
  - Operational interconnectedness, including shared services;
  - Counterparty actions with respect to derivative trades and collateral; and
  - Maintaining funding and liquidity.

- Stress Scenario Used in SIFI Resolution Plan. CIDIs are expected to account for the failure of the CIDI under three economic scenarios: baseline, adverse, and severely adverse. CIDIs should focus on the same economic scenario that was the principal focus in the SIFI Plan, which in most cases has been the severely adverse scenario. The CIDI can then explain changes to plan assumptions, strategies, obstacles, and mitigants under the remaining two scenarios.

- Other Issues of Note. The Guidance requires detailed consideration of additional issues, such as Critical Services, Key Personnel, major counterparties, and corporate governance. A general discussion is provided on each issue.

  - Critical Services. Critical Services should be carefully designated and mapped to and from Material Entities, Core Business Lines, and key data centers. Potential obstacles and proposed mitigants should be discussed.
  - Key Personnel. CIDIs should consider identifying key personnel for resolution and bridge bank operations by position title and function. The positions should be mapped to Critical Services and Core Business Lines.
  - Major Counterparties. CIDIs should identify the major counterparties of the CIDI.
  - Corporate Governance. The CIDI should include a description of how resolution planning is integrated into the corporate governance structure and processes of the CIDI. The CIDI should identify a senior management official who is primarily responsible for the resolution plan.

In conclusion, the FDIC's new Guidance requires much more granularity in the presentation and supporting analyses for the CIDI resolution plans than has been required in prior guidance provided by the FDIC. In effect, the FDIC appears to be requiring a detailed strategic resolution plan for the CIDI that could, if necessary, be implemented in a receivership and bridge bank of that CIDI. These requirements will increase the complexity of the CIDI plans as well as the costs of complying with the resolution planning requirement while potentially impairing the focus on and coherence of the narrative of the resolution strategies.

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