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Financial Institution Recovery and Resolution Plans

As part of the response to the recent financial crisis, lawmakers and bank supervisors have put forth proposals that would require some financial institutions to prepare, review, outline and report on recovery and resolution plans ("RRPs"), which are sometimes known as "living wills." Recovery plans, which come into play when a firm falls under extreme stress, outline actions to maintain the firm as a going concern. Resolution plans would be resorted to in the event of failure of a financial institution and would aim to manage its resolution in a controlled manner with minimum cost and systemic disruption.

Overview

Currently, the U.S. is considering requirements for systemically important financial institutions to develop plans to take appropriate action to reduce the risk of failure and the impact of a failure. RRP would generally provide regulators with an inside view of a systemically important financial institution's concentration of risk. Under relevant U.S. legislative proposals, a financial institution is considered systemically important if its failure would have economically significant effects that could destabilize the financial system, with a potential negative macroeconomic impact. A systemically important financial institution would be required to prepare and provide to regulatory authorities a plan for orderly resolution in a material financial distress or failure event, intended to give regulators a more comprehensive understanding of the institution's ownership structure and exposures to and connections with other affiliated and unaffiliated institutions.

In the UK, legislation has recently been passed which requires the Financial Services Authority (the "FSA") to make rules requiring all banks and investment firms, or banks and investment firms of a specific description, to prepare and maintain a RRP. This requirement on the FSA comes into effect on June 8, 2010 and the FSA is

expected to consult on detailed rule proposals later this year, including on whether it intends to limit the requirement to prepare RRP to financial institutions of a certain size or type.

In Europe, formal legislative proposals on RRP have not yet been put forward. However, there has been a great deal of discussion about how best to deal with systemically important financial institutions in times of stress or market disruption. Before proposing legislation the European Union intends to set up Cross Border Stability Groups, which would develop international standards for the preparation of RRP for systemically important financial institutions by the end of 2010. Those RRP may be used to contribute to developing European regulatory policy on RRP as well as the broader issues involved in the resolution of financial institutions that operate cross-border.

Recent Proposed U.S. Legislation and Administrative Rules

As described below, both the U.S. House of Representatives and the U.S. Senate have passed companion financial reform bills that would require systemically important non-bank financial institutions

and some large banking groups to develop a RRP. Both legislative proposals identify systemically important firms by reference to the following characteristics, among others:

- The U.S. financial system's interdependence with the financial institution;
- The financial institution's size, leverage (including off-balance sheet exposures), and degree of reliance on short-term funding; and
- The financial institution's importance as a source of credit for households, businesses, and governments and as a source of liquidity for the financial system.

In addition, under the U.S. Senate's legislation, institutions subject to the RRP requirement include large, interconnected U.S. bank holding companies with at least \$50 billion in consolidated assets.

In addition to these legislative proposals, the Federal Deposit Insurance Corp. ("FDIC") is currently seeking comments on a similar proposal that would require certain insured depository institutions ("IDIs") that are subsidiaries of large and complex financial parent companies to create a plan for their own liquidation in the case of financial distress.¹ An important objective would be to demonstrate in the plan that the IDI could be wound down or resolved efficiently and separately from its parent company. The FDIC proposal would apply only to IDIs with greater than \$10 billion in total assets that are owned or controlled by parent companies with more than \$100 billion in total assets.

U.S. House of Representatives Legislative Proposal

The financial regulatory reform bill passed by the U.S. House of Representative ("House Bill")² would require the Federal Reserve Board and FDIC to issue rules requiring systemically important financial institutions to present a RRP to the Federal Reserve Board ("Federal Reserve") and FDIC.³ The RRP would be designed to "assist in the rapid and orderly resolution of the company."

Under the House Bill, each RRP would need to:

- Demonstrate that any depository institution affiliated with the institution preparing the RRP is insulated from the activities of any non-bank subsidiary of the institution;⁴ and
- Include information detailing (i) the extent of credit exposure to other significant financial companies; (ii) the extent to which other significant financial companies have credit exposure to the plan's subject institution; (iii) full descriptions of the ownership structure, assets, liabilities, and contractual obligations; and (iv) the cross-guarantees tied to different securities, a list of major counterparties, and a process for determining where the institution's collateral is pledged.⁵

RRPs would be periodically updated and submitted to the Federal Reserve and FDIC for review on no less than an annual basis.⁶

U.S. Senate Legislative Proposal

The financial regulatory reform bill passed by the U.S. Senate (the "Senate Bill") calls for the Federal Reserve to require each systemically important financial institution

¹ See Notice of Proposed Rulemaking "Special Reporting, Analysis and Contingent Resolution Plans at Certain Large Insured Depository Institutions" FDIC Release RIN 3064-AD59 (May 11, 2010), 75 Fed. Reg. 27464 (May 17, 2010), currently available at: <http://www.fdic.gov/news/board/May01.pdf>. The FDIC's notice seeks comments, which must be submitted on or before July 16, 2010.

² See Wall Street Reform and Consumer Protection Act of 2009, H.R. 4173. The House Bill passed in 2009, and will be reconciled with the U.S. Senate legislation prior to becoming law.

³ See *id.* at Section 1104(i)(1).

⁴ See *id.* at Section 1104(i)(2)(B).

⁵ See *id.* at Section 1104(i)(2)(C).

⁶ See *id.* at Section 1104(i)(3)(B).

(including some large banking groups with over \$50 billion in assets) to:

- Report periodically to the Federal Reserve, FDIC and a council of senior financial agency leaders (the "Financial Stability Oversight Council"), to be established under the Senate Bill to serve as a systemic regulator, the plan of such company for rapid and orderly resolution in the event of material financial distress or failure;⁷ and
- Report periodically to the Federal Reserve, FDIC and Financial Stability Oversight Council regarding credit exposure to other systemically important institutions, and on other systemically important institutions' credit exposure to the subject institution.

Other reporting requirements included in the Senate Bill should effectively complement information required to be included as part of a formal RRP. For example, the systemic regulator would also be able to require certain systemically important financial institutions to report on: (i) the financial condition of the company; (ii) systems for monitoring and controlling financial, operating, and other risks; (iii) transactions with any subsidiary that is a depository institution; and (iv) the extent to which the activities and operations of the company and any subsidiary thereof, could, under adverse circumstances, have the potential to disrupt financial markets or affect the overall financial stability of the United States.

Federal Deposit Insurance Corporation Proposal

As manager of the fund that protects consumers' insured deposits and as receiver of insolvent insured depository institutions, the FDIC has a strong interest in gaining access to information that allows it to quickly assess its

risks and to resolve IDIs in a cost-effective and timely manner in the event of failure.⁸

Under the FDIC proposal, IDIs would be required to confidentially submit to the FDIC analysis, information, and so-called "contingent resolution plans" that address and demonstrate the IDI's ability to be separated from its parent structure (in order to better preserve the value of the IDI's assets in the event of the IDI's failure), and to be wound down or resolved in an orderly fashion.

As described below, the contingent resolution plan, gap analysis, and mitigation efforts are intended to enable the FDIC to develop a reasonable strategy, plan or options for the orderly resolution of the institution. The FDIC's proposal would require IDIs to disclose detailed information about their technology, payment systems, exposure to other IDIs and their capital structure. The IDIs would also have to provide sufficient information to allow regulators to determine whether the IDIs pose a "systemic" risk to the economy.

Specifically, an IDI would be required to disclose, at a minimum, details about:

- Its organizational structure, including the disclosure of certain key personnel;
- Events and fiscal challenges that have had a material effect on it and its relationship with its parent or affiliates;
- Its short- and long-term goals to prevent impediments to separation and resolution;
- The nature and extent of its involvement in payment systems, custodial or clearing operations, large sweep programs and capital market operations in which it plays a dominant role;
- The nature and extent of its cross-border interrelationships and exposures, including the individual components of the group structure that

⁷ See Section 165(d) of the Senate Bill, currently available at: http://banking.senate.gov/public/_files/TheRestoringAmericanFinancialStabilityActof2010AYO10732_xml0.pdf.

⁸ As receiver, the FDIC must liquidate or sell assets that may be rapidly declining in value while at the same time meeting commitments to pay insured depositors of the failed institution.

are based or located outside the U.S., such as its foreign branches, subsidiaries and offices;

- Its size relative to its parent company and the interdependence with the national and international marketplaces; and
- Its capital structure as well as its parent's capital structure.

The plans would have to be approved by the IDI's board of directors or executive committee. In addition, the plans would identify a time frame within which identified remediation or mitigation efforts to prevent severe financial distress would be achieved.

Separately, the Federal Reserve, the "umbrella" regulator of U.S. bank holding companies, has begun a similar effort aimed at determining how best to set up contingency plans for the orderly wind-down of the institutions it oversees.

UK Developments

The Financial Services Act 2010, which was passed in April this year, mandates the FSA to make rules requiring banks and investment firms to prepare and keep up-to-date RRP.⁹ The provisions on RRP come into force on June 8, 2010.¹⁰ Under the new Act, the FSA must also consider whether the RRP is satisfactory and take steps to remedy any shortcoming, including requiring banks and investment firms to revise the RRP. In preparing the rules, the FSA must have regard to any relevant international standards. The FSA will also need to consider any future EU legislation on RRP.

Prior to the enactment of the Financial Services Act 2010, the FSA had already begun considering the introduction of RRP. In October 2009, the FSA published proposals on requiring systemically important financial institutions to prepare RRP.¹¹ Since then, the FSA has expanded on

those proposals in various communications. A summary of the FSA views to date is set out below. Further consultation on the proposed detailed FSA rules is expected in 2010/2011.

Recovery Plans

The recovery plan would need to set out the firm's plans for how it would respond to severe stress and set out the steps that the management of the firm would take in stress situations. For each action identified, the firm would need to set out the process for deciding upon and executing the plan, the circumstances in which the plan would be appropriate, the key dependencies, the information required and any legal, financial and operational constraints.

The recovery plan would need to include the following:

- A capital recovery plan;
- A liquidity recovery plan;
- A contagion control plan (how the firm would deal with the failure of its largest counterparties); and
- Information on how the firm's recovery could be supported by management actions to reduce risks to which the business is exposed.

The options proposed in the recovery plan would be evaluated according to the following criteria:¹²

- The ability to execute the option within a reasonably short time frame (no longer than six months);
- The material impact the action is likely to have on the institution so that the firm has a reasonable chance of continuing as a going concern;
- The diversity of options available; and
- The credibility of the options to key stakeholders such as shareholders, debt holders, depositors, counterparties, central banks and supervisors.

⁹ Financial Services Act 2010, section 7.

¹⁰ Financial Services Act 2010, section 26.

¹¹ The Turner Review Conference Discussion Paper (October 2009).

¹² Speech by Thomas F. Huertas, FSA: *Living Wills: How Can the Concept be Implemented* dated February 12, 2010.

Resolution Plans

In the event of failure of a UK financial institution, the authorities would determine the appropriate course of action within the appropriate resolution framework. Currently there is a Special Resolution Regime for deposit-takers under the Banking Act 2009, which includes options for partial transfer of assets and liabilities to a bridge bank or private sector purchaser, whole bank transfer of assets and liabilities, and temporary public ownership. Other UK financial institutions would be subject to the general UK insolvency regime.¹³

The resolution plan would focus on the information required to be provided by the firm and the best means of doing so, including through a virtual data room, in the shortest possible timescale depending on the resolution options available. The information required would include:

- The legal structure of the group, including the basis of the relationship such as the legal status, financial, staffing and premises;
- Contingency arrangements in case of interruption to that relationship;
- Any legal, financial or operational obstacles to the authorities using any of the possible resolution regimes;
- The identification of the market and payment infrastructures to which the firm is connected and a plan for the firm to disconnect from those systems in an orderly manner;
- Information on the segregation of client assets and the procedures by which segregated assets could be transferred to third parties;¹⁴ and

- Information on the firm's deposit base, including which deposits are insured or not and the maturity structure and terms and conditions of the deposits.

The FSA's powers to require the preparation of RRP's are not limited to systemically important financial institutions (as is currently proposed in the U.S.). In the Turner Review Discussion Paper, the FSA stated that it was "minded to extend the requirement for recovery and resolutions plans to include all UK deposit takers, in addition to systemically important firms."

There is no current definition from the regulator as to what constitutes a systemically important firm. In the above-mentioned paper, the FSA states that "[i]n general, a firm is systemic when its collapse would impair the provision of credit and financial services to the market with significant negative consequences for the real economy." The FSA considers that three factors make a firm systemically important: size, inter-connectedness and systemic as a herd (i.e., where the market perceives a group of firms as part of a common group or common exposures to the same sector or type of instrument).

Thinking About and Preparing for RRP's

To prepare and present RRP's to U.S., UK, and international authorities, financial institutions will need to coordinate with trusted counsel, accountants and local counsel for relevant jurisdictions. Relevant expertise, cross-border understanding of financial institution assets and insolvency regimes, and cross-border coordination will be essential to putting together feasible RRP's.

We are working with financial institution clients to think through how RRP's should be prepared, presented and maintained. In doing so, we have developed a cross-border, interdisciplinary team to work with clients from around the globe on asset and exposure identification and contractual diligence, swaps and derivatives diligence and exposure, litigation exposure, regulatory regimes, bankruptcy and insolvency regimes, and capital markets and M&A recovery options. Our Shearman & Sterling team members are listed below.

¹³ The UK Government issued a consultation paper entitled "*Establishing Resolution Arrangements for Investment Banks*." The consultation closed on March 16, 2010 and the Government is expected to publish firmer proposals and draft legislation later in 2010.

¹⁴ The FSA is currently consulting on amending its rules relating to client money and assets. See http://www.fsa.gov.uk/pubs/cp/cp10_09.pdf.

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This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

If you wish to receive more information on the topics covered in this memorandum, you may contact your regular Shearman & Sterling contact person or any of the above.

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