Peeling back the 2017 resolution planning guidance
Summary of the 2017 section 165(d) guidance for domestic covered companies that submitted resolution plans in July 2015
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Introduction

April 13, 2016 was a key milestone date for the evolution of resolution planning in the United States (US). For the first time, the Federal Reserve Board (FRB) and the Federal Deposit Insurance Corporation (FDIC) (collectively, the “agencies”) jointly determined that certain plans submitted by large banking organizations were “not credible or would not facilitate an orderly resolution” under the US Bankruptcy Code, a finding that requires the firms to revise their plans to demonstrate credibility. Institutions with resolution plans deemed not credible have until October 1, 2016 to address the identified deficiencies.

Further, the agencies more clearly described the criteria for evaluating resolution plans and more transparently described the rationale for individual firm resolution plan determinations. For the first time, the agencies disclosed high-level components of their Resolution Plan Assessment Framework used to evaluate and issue joint determinations on the 2015 resolution plans. In addition, they publicly released redacted versions of the feedback letters submitted to individual institutions. This approach underscores the significance the agencies place on resolution planning and their belief in the public’s right to know the degree of progress being made at systemically important institutions on ending “too big to fail.”

Significantly, as part of the announcements, the agencies provided explicit guidance outlining expectations for the next full resolution plan submissions, which are due by July 1, 2017. This guidance further raises the bar and sets more specific standards that will affect all eight US global systemically important banks (G-SIBs)—not just those found to have deficiencies in their 2015 resolution plan. Avoiding deficiency determinations in July 2017 will require firms to develop a fulsome understanding of gaps and action plans across the areas described by the new guidance.

Key Takeaways from April 13 FRB and FDIC Resolution Planning Announcement

- Regulators have significantly raised their expectations: Regulators believe firms have fallen short strategically and operationally at overcoming resolvability issues
- Quick turnaround time to address deficiencies: Five firms have until October 1, 2016 to address the identified deficiencies
- Next full resolution plan submissions due by July 1, 2017: The agencies are dropping the July 2016 full plan submission deadline. All eight G-SIBs have a revised 2016 submission due by October 1, 2016. The scope of the required submission is tailored to the agencies’ resolution plan determination and firm-specific feedback letter
- The 2017 Guidance should not be overlooked: The 2017 Guidance highlights additional capabilities that are required by July 2017; firms should start determining their gaps and devise action plans to achieve the additional capabilities now required for an adequate plan and state of resolvability
- Increased transparency from agencies: The public documents identifying the criteria by which the agencies reviewed the plans and guidance on expectations for each of the critical areas—coupled with the actual feedback letters to the banks—have improved the transparency of the process. The guidance for the 2017 plan submissions further pressures banks to publicly demonstrate improvement

Resolution plan determinations of eight US G-SIBs

For a plan to be deemed not credible under Section 165(d) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), the FRB and the FDIC must jointly make a “not credible” determination. Split votes may require remedial efforts but do not result in the more serious consequences of a unanimous determination. That should not be interpreted by an institution as needing to put less emphasis on remediation efforts. If an issue was identified by one or both of the agencies, the effort needs to be strong with a clear plan to remediation.

The agencies characterized the severity of their findings as deficiencies or shortcomings as follows:

- **Deficiency**: A weakness that individually or in conjunction with other aspects could undermine the feasibility of the firm’s plan. Firms with jointly identified deficiencies were deemed to have “not credible” plans and must address the deficiencies by October 2016.

- **Shortcoming**: A weakness identified by the agencies that is not considered a deficiency, but raises questions about the feasibility of the plan. Identified shortcomings must be remediated by the next full plan submission in July 2017.

The agencies jointly determined that the plans submitted by five G-SIBs were “not credible or would not facilitate an orderly resolution under the Bankruptcy Code.” Further, for two other institutions, the agencies were split on whether any deficiencies existed, though both agencies identified shortcomings. One institution had no jointly identified deficiencies by either agency and avoided a “not credible” joint designation; however both agencies identified certain shortcomings with the plan.

The underlying message is that all plans still have substantial work left, with some firms needing more work in certain areas than others. There was some relief provided, however; the agencies waived the July 2016 full plan submission deadline for the eight US G-SIBs, but required all firms to submit a status report on actions to address any deficiencies and shortcomings, as well as a public section that explains these actions at a high level, by October 1, 2016 (October 2016 submission).

The scope of what is required in the October 2016 submission differs among institutions based on the agencies’ resolution plan determination and firm-specific feedback letter.

Section .5(c) of the agencies’ resolution plan rule outlines the requirements to resubmit a deficient resolution plan. Requirements under section .5(c) highlight that the institution must submit a revised resolution plan to the agencies that addresses deficiencies identified. Further expectations for the October 1, 2016 submission are outlined in each institution’s feedback letter, and the agencies highlighted that the 2016 submission is not required to contain informational content other than what is as specified in the feedback letter. This limits the scope

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**2016 Resolution Plan Submission Expectations:**

**For plans with identified shortcomings and no deficiencies:**

- Public section that explains planned actions to address the shortcomings
- Status report of actions to address shortcomings

**For plans with identified shortcomings and deficiencies:**

- Public section that explains planned actions to address the shortcomings and actions taken to remediate deficiencies
- Status report of actions to address shortcomings
- Detailed explanation of revisions made by the institution to address the jointly identified deficiencies
of content in the 2016 submission to focus on the shortcomings and/or deficiencies identified.

If the agencies jointly agree that an institution has not adequately remediated deficiencies, section .6 of the resolution plan rule allows the agencies to impose additional prudential requirements (e.g., additional capital, leverage, or liquidity requirements) on the firm until it remediates the deficiencies. Upon imposing additional prudential requirements and if the firm has still failed to adequately remediate deficiencies, the FRB and FDIC, in consultation with the Financial Stability Oversight Council (FSOC), may require the firm to divest assets or operations after a two-year period.

The key is for institutions to demonstrate to the agencies that they are resolvable to avoid detrimental measures on the part of the agencies, such as increased capital or liquidity requirements as provided by the Dodd-Frank Act. Many of the deficiencies and shortfalls cannot be addressed fully in the timeframes provided given the complex nature of the issues that are involved. In these cases, detailed project plans need to be developed that include what can be achieved by the October 2016 and July 2017 dates along with specific milestones that can be used by both the institutions and the agencies to assess progress.

Firm-Specific Feedback Letters:
The FRB and FDIC provided each institution with specific feedback letters that detail the shortcomings and/or deficiencies of each firm’s plan and provide specific remediation required of each firm; the letters range from nine to thirty pages.

The same feedback letters with certain text redacted were released to the public as part of the announcement of resolution plan determinations. The approach the agencies took to make public firm-specific feedback letters in redacted form has significantly expanded the type of information the agencies consider to be suitable for public consumption as it allows for differentiation of performance.

As documented in the firm-specific feedback letters, the agencies identified shortcomings in all eight G-SIBs’ resolution plans, all of which require remediation actions.

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<th>Theme</th>
<th>Finding Type</th>
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<td>Capital</td>
<td>Deficiency</td>
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<td>Shortcoming</td>
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<td>Liquidity</td>
<td>Deficiency</td>
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<td>Governance</td>
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<td>Shortcoming</td>
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<td>Operational</td>
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<td>Shortcoming</td>
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<td>Legal Entity Rationalization</td>
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<tr>
<td>Derivatives and trading</td>
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The resolution plans submitted by each institution in July 2015 were the basis for the resolution plan determinations and assessments of shortcomings and deficiencies. However, following the July 2015 resolution plan submissions, institutions have continued to make progress on ex-ante projects which may relate to shortcomings and/or deficiencies.

To understand the impact of the regulatory findings and the additional capabilities that are required by the 2017 Guidance, institutions will need to assess their letters and understand what progress has been made to date and how it aligns with the expectations in the guidance. Remediation of deficiencies should be prioritized as the October 1, 2016 deadline is approaching.

Overview of July 2017 Resolution Plan Guidance:
The 2017 Guidance is intended to be further clarification of previous guidance and specific feedback that was provided to institutions. The 2017 Guidance provides the basis for the next full plan submissions for the eight US G-SIBs.

The agencies also expect institutions to adhere to the 2013 guidance, the 2014 firm-specific feedback letters and the 2015 firm-specific communications, except in instances where these have been superseded or supplemented with 2017 Guidance.

The 2017 Guidance includes 23 pages of additional expectations across the areas in which the agencies have identified key vulnerabilities with respect to resolution. The 2017 Guidance outlines expectations for addressing these key vulnerabilities, such as enhancing capabilities, requiring detailed analysis, and/or requiring optionality.

The 2017 Guidance further emphasizes the expectation that institutions have capabilities described in the FRB’s Supervision and Regulation (SR) Letter 14-1 and capabilities to execute its resolution strategy.

Although July 2017 is over a year away, the more detailed expectations outlined in the 2017 Guidance may cause challenges for institutions, which creates urgency for them to begin preparing now.

2017 Guidance Areas of Key Vulnerabilities
The 2017 Guidance outlines expectations across seven areas:

• Capital
• Liquidity
• Governance
• Operational
  – Payment, Clearing and Settlement
  – Collateral
  – Management information Systems
  – Shared and Outsourced Services
  – Legal Obstacles
• Legal Entity Rationalization and Separability
• Derivatives and Trading Activities
• Public Section

These areas, with the exception of the Public Section, are also highlighted as the areas the agencies evaluated as part of their Resolution Plan Assessment Framework.

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<tr>
<th>Theme</th>
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<th>Observations</th>
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<tr>
<td>Capital</td>
<td>Resolution Capital Execution Need (RCEN): Capability to estimate the amount of capital that would be needed to support each Material Entity (ME) after the bankruptcy filing.</td>
<td>Several institutions needed to more fully flesh out a specific rationale for the capital level, its prepositioning and ultimate recapitalization strategy for their MEs to meet supervisory expectations.</td>
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<td>Resolution Liquidity Adequacy and Positioning (RLAP): Institutions are expected to have capabilities to measure the stand-alone liquidity position for each ME and ensure liquidity is readily available to meet liquidity needs; this includes ME that are non-US Branches.</td>
<td>Industry reluctance to pre-position liquidity at the ME subsidiary level similar to capital discussion. The industry prefers to maintain liquidity at the parent level to be down streamed to subsidiaries as the need arises, this way liquidity is not trapped at non-troubled MEs.</td>
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<td>Resolution Liquidity Execution Need (RLEN): Capability to estimate the liquidity needs after bankruptcy filing that incorporates minimum operating liquidity, daily cash flow forecasts, peak funding needs at each ME.</td>
<td>Firms have presented liquidity forecasts post-bankruptcy for MEs using liberal assumptions about credit rating agency responses, counterparty responses, and jurisdictional ring fencing.</td>
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<td>Governance Triggers and Actions: Defined triggers and thresholds and, in certain cases, actions to be taken by the board and senior management when the metric is breached.</td>
<td>Firms prefer flexibility to take certain actions based on the scenario at any given point in time in the resolution process. Shifting toward a hard trigger framework may require additional upfront planning and metric calibration across the organization.</td>
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<td>Criteria should support the firm’s preferred resolution strategy, and also give consideration to the best alignment of legal entities and business lines to improve resolvability under a variety of market conditions.</td>
<td>Firms have prepared criteria that do not necessarily incorporate resolvability as part of business-as-usual (BAU) activities. Additionally, firms have detailed business efficiencies as trumping resolvability issues. The agencies are requesting that firms incorporate resolvability as part of their BAU processes, and also provide for more optionality in their plans based on the perceived fragility of the plans. Separability of business units/lines from legal entities allows for multiple potential responses to market conditions at the time of stress.</td>
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<td>Payments, Clearing and Settlement Activities: Playbooks should be developed to allow for continuity and an orderly resolution.</td>
<td>Firms have developed playbooks that attempt to address operational resolution vulnerabilities, some more effectively in the regulators’ opinion than others. Financial Market Utility (FMU) playbooks as an example are generally comprehensive, but still cannot overcome the FMU ability to take actions at the time of stress which may be adverse to the resolution strategy being pursued by the firm.</td>
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<td>Managing, Identifying and Valuing Collateral: Regulatory expectations have been significantly elevated with respect to a firm’s comprehensive understanding of the collateral it receives and posts to external parties and affiliates.</td>
<td>Firms ability to meet the regulatory expectations have been based more on BAU processes with extended timeframes required to aggregate positions along with other issues related to inadequate IT systems and rehypothecation. The regulators’ expectations in this area have not been satisfactorily met by most firms.</td>
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<td>Development of additional wind-down analysis: The agencies have repeatedly emphasized robust solvent wind-down analysis, and in the guidance for the 2017 resolution plan, the agencies reiterated considerations for active and passive solvent wind-down analysis, with the added dimension of detailed quantitative estimates related to derivatives portfolios</td>
<td>Firms would need to demonstrate with adequate detail their solvent wind down analysis, especially with their passive wind down analysis. However, some firms which have significant trading operations in UK have already developed capabilities and processes in the UK to furnish this information, and they can look to leverage those capabilities to fulfill the expectations of the US regulators.</td>
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<td>Rating Agency Playbook: Development of a rating agency playbook to facilitate the stabilization of each trading entity following the bankruptcy filing of the parent company</td>
<td>While some firms have incorporated rating agency behavior in their assumptions for runway and resolution, as well as in their communication strategy, they are expected to develop detailed playbooks outlining the strategy and the plan to maintain, reestablish, or improve ratings to investment grade or equivalent for each trading entity.</td>
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These requirements are only applicable to the four dealer firms as identified in the 2017 Guidance.
The capital section of the 2017 Guidance focuses on resolution plan enhancements to adequately analyze and anticipate capital resources needed to ensure the continued operation of MEs, and execution of the resolution strategy.

The guidance asks firms to answer three inter-related questions:

• **How much aggregate Total Loss Absorbing Capacity (TLAC) is needed firm-wide in the form of capital and long term debt to recapitalize MEs and effect an orderly resolution?**

• **Where should TLAC be pre-positioned within the firm (internal TLAC), to ensure continuity of ME operations on the one hand while maintaining flexibility at the parent level to meet unanticipated capital needs during an actual resolution event?**

• **How much capital is needed at each ME to absorb losses and be recapitalized to a level that allows for an effective wind down or continued operations over the course of an orderly resolution?**

**How much aggregate total loss absorbing capacity is needed firm-wide?**

TLAC requirements build on the Basel III capital framework, and require firms to hold additional "bail-in" capital (i.e., debt convertible to equity during resolution) to ensure capital availability in the time of distress.

To calculate aggregate TLAC, firms will need to include a buffer on top of existing Risk-Weighted Assets (RWAs) and leverage ratio requirements, while also maintaining minimum levels of eligible long term debt. For US G-SIBs, the external TLAC buffer is equal to the sum of (2.5% + G-SIB surcharge as per Method 1 + applicable countercyclical buffer), and for covered IHCs, the buffer is equal to sum of (2.5% + applicable countercyclical buffer). This regulatory external TLAC minimum should be compared with internal TLAC needs to ensure it all adds up.

**Where should TLAC be pre-positioned within the firm?**

The guidance requires firms to strategically position TLAC prior to resolution in a way that carefully balances the tradeoff between the certainty of pre-positioning capital where it is likely needed, against the benefits of maintaining "dry powder" capacity at the parent.

On the one hand, holding dry powder at the parent keeps recapitalization options open, but on the other, it poses risks of legal challenges and other barriers that could threaten the success of the recapitalization effort. Consequently, firms are required to perform sufficient diligence to ensure appropriate strategy with support and substantiation.

**How much capital is needed at each ME?**

The 2017 Guidance prescribes that firms develop a methodology to periodically estimate the capital required at each ME to absorb losses and recapitalize the entity after bankruptcy, known as the RCEN. RCEN estimates are to be incorporated within governance frameworks, to ensure that firms mobilize capital appropriately prior to filing for bankruptcy and in-time to execute their resolution strategy.

The 2017 Guidance specifies that the RCEN estimation methodology should be based on conservative loss forecasts, and cover any additional capital required during the resolution period. The guidance also requires that the methodology ensure recapitalized MEs have adequate capital to maintain market confidence, and retain "well capitalized" regulatory status (or equivalent level of financial soundness) throughout resolution.

**Our take on the 2017 Guidance and expected capabilities**

Given the nature of resolution plan requirements, the guidance on capital impacts a broad range of areas:

• **Governance:** Firms will need to update their governance processes to incorporate RCEN estimates within their resolution strategy, in order to determine when to inject capital into MEs and file for bankruptcy.

• **Implementation:** Adequate controls to monitor loss absorbing capital will be required to trigger necessary actions and processes defined under RRP, and ensure an orderly resolution. Firms may need to update policies on issuance of intercompany debt (where there are one or more entities between the ME and parent) to mitigate the possibility of a creditor challenge (i.e., by promoting standardized seniority and tenor).
**Methodology:** RCEN estimation methodology will need to be developed with necessary substantiation to pass an independent review. For each ME, this analysis will include:

- The degree of balance sheet and capital impairment up through the resolution runway
- The risk profile of the organization, particularly aspects that drive capital required by regulators or the market place, both at bankruptcy and through the resolution period
- The target level of recapitalization needed for a ME subsidiary of a firm in resolution to continue its operations or wind them down through the resolution time frame while maintaining the confidence and cooperation of regulators, counterparties and the market place
  
  i) For insured depositories, this means at least well-capitalized and, for others, at least their minimum regulatory capital requirements and at least investment grade equivalent soundness

- Ultimately, the delta between the impaired capital position and the target capital position will define the RCEN and estimates should include a reasonable degree of conservatism to reduce the likelihood of shortfalls.

**Prepositioning:** Firms will need to develop a strategy for pre-positioning TLAC with MEs, and support it through sufficient analysis, including the tradeoffs between prepositioning and maintaining flexibility or dry powder at the parent

**Data:** Availability of accurate historical data and suitable forecasting estimates for each ME could be important constraints in development of the RCEN methodology. In addition, sufficient data to maintain estimates on a go forward basis would be necessary to ensure ongoing capital allocation across MEs

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**Our take on key ingredients to success**

In our experience, addressing capital needs up to and through resolution is a team sport. Some key ingredients to success include:

- **Involve and make accountable Risk, Finance and Business Lines:** Not dissimilar from efforts under the FRB’s Comprehensive Capital Analysis and Review (CCAR), it takes a village to create a credible capital plan. Risk, Finance and Business leaders are all needed to develop the analysis that informs how much TLAC to hold at the top of the house, how much is needed at the ME level during resolution, and how much should be prepositioned at the ME level given its RCEN

- **Leverage stress testing and capital planning infrastructure and subject matter experts:** Firms that have avoided balkanizing their CCAR and RRP groups have been more effective at tapping important synergies and avoiding duplicative or conflicting processes or estimates

- **Normalize resolution capital planning into BAU:** As MEs grow and evolve, so too will their capital needs through resolution. Just as going concern capital needs are evaluated on an ongoing basis, so should gone concern estimates be incorporated into a BAU process with sufficient resources and infrastructure to avoid annual “fire drills” and normalize this work into day to day operations

- **Recognize the need for data quality, controls and effective challenge:** Given the extensive use of data to drive the analysis coupled with models and expert judgment, the same level of care should be exercised as in other areas in establishing and documenting a control framework that ensures integrity of the conclusions around capital needs
The 2017 Guidance reiterates and builds on the guidance provided in SR 14-1. Firms are expected to be able to estimate liquidity required (including for critical services and FMUs) going into and during resolution, by each ME. They must be able to measure and monitor the sources and uses of liquidity under normal and stressed conditions. But importantly, this analysis must take into account “frictions” in the movement of liquidity from one entity to another.

The 2017 Guidance organizes the liquidity forecasting requirements by introducing two new terms, RLAP and RLEN.

- **Resolution Liquidity Adequacy and Positioning (RLAP):** The standalone liquidity needs of each ME for 30 days of stress.
  - Firms should be able to calculate the standalone liquidity position (High Quality Liquid Assets (HQLA) less net outflows to third parties or affiliates) for each ME and ensure liquidity is available to meet deficits
  - Should cover at least a 30 day period
  - Parent holding company should hold sufficient HQLA to cover the sum of all standalone ME deficits
  - Should use internal stress test assumptions, tailored to the idiosyncratic liquidity profile and risk of the firm
  - Should treat affiliates in the same manner as third parties
  - Should take into account the daily contractual mismatches between inflows and outflows, the daily movements of cash and collateral between affiliates, and the stressed flows and trapped liquidity due to actions taken by clients, counterparties, FMUs, and foreign supervisors.

- **Resolution Liquidity Execution Need (RLEN):** The estimated liquidity needed post-bankruptcy filing to support the surviving and/or wind-down entities. The RLEN methodology should:
  - Provide daily cash flow forecasts to support an estimate of peak liquidity requirements during stabilization period for each ME
  - Provide breakdown of all inter-affiliate transactions and arrangements that could impact the above calculations
  - Provide the board(s) of directors an estimate of the minimum liquidity needed at each ME to inform their decision on timing of resolution decisions.

The guidance re-emphasized the importance of balancing the pre-positioning of liquidity at MEs and holding liquidity at the holding company. The former avoids impediments to moving funds across legal entities and the latter gives the parent the flexibility to allocate liquidity where it is needed most. It clearly states that firms must not assume that a net liquidity surplus in one ME can be moved to meet liquidity deficits at another ME or can be moved to the holding company.

Our take on the 2017 Guidance and expected capabilities

The 2017 Guidance focused on perceived flaws in liquidity calculation methodologies and assumptions. The two largest issues were:

- **Liquidity transfers between affiliates:** Some firms were criticized for what the regulators viewed as flawed assumptions about the mobility of liquidity between MEs during the so-called “runway” period. These firms will need to address these shortcomings and modify assumptions about defensive ring-fencing in other jurisdictions. These changes could potentially result in a need to reposition or add to liquidity reserves. While the regulators encouraged firms to balance where liquidity reserves are held, they should be prepared to defend their approach.

- **Unsupported assumptions:** Several firms were found to have other deficiencies in their models for estimating the liquidity needs of the MEs. The letters to these firms provide specific examples of some of the deficiencies which suggest a lack of transparency and specificity in the assumptions and methodologies employed. These firms would do well to look beyond the examples
provided and look critically at all of the assumptions and modeling techniques and how they are documented in the plan.

Our take on key ingredients to success

• **Document your assumptions and be specific:** One overarching theme of the feedback letters was that firms need to improve their documentation of assumptions. Lack of specificity about the models and process in certain areas led the reviewers to question the validity of the entire model. Firms that are very clear and specific on their assumptions will likely give the reviewers greater confidence in the plan.

• **Treat affiliates at arm’s length:** Firms that treat peer-to-peer affiliate transactions with the same skeptical assumptions as third-party transactions will be viewed more favorably than those that don’t. That said, firms are encouraged to put into place liquidity provisions, for example in the form of committed lines of credit, at the holding company for downward flows to specific MEs.

• **Create daily forecasts for the most critical periods:** Based on the guidance and letters, firms should use daily forecasts for the 30 day runway period and for at least 30 days of stabilization after bankruptcy filing.
In the 2017 Guidance, the FDIC and FRB noted two areas of focus for the Governance Mechanism section: playbooks and triggers, and pre-bankruptcy parent support.

The first requires firms to “identify the governance mechanisms that would ensure execution of board actions as appropriate and include pre-action triggers and existing agreements for such actions.” Specifically, the governance playbooks should not only include actions to facilitate the firm’s preferred strategies but also actions to mitigate vulnerabilities. They should also incorporate triggers that are based, at a minimum, on capital, liquidity, and market metrics. These clearly identified triggers should be linked to specific actions for a) escalation of information, b) effective recapitalization of subsidiaries, and c) timely execution of bankruptcy filing and related pre-filing action throughout the phases of the crisis continuum.

The second area of focus is the inclusion of a detailed analysis of the potential legal challenges and mitigants to planned provisions of capital and liquidity to subsidiaries prior to the parent’s bankruptcy filing. In identifying appropriate mitigants, the firm should consider the effectiveness of a contractually binding mechanism (CBM), prepositioning of financial resources, and the creation of an intermediate holding company. The CBM should also include, among other things, clearly defined triggers that are synchronized with the firm’s liquidity and capital methodologies.

Our take on the 2017 Guidance and expected capabilities
The agencies’ feedback cited either shortcomings or deficiencies in the Governance Mechanism area for all firms except one. It appears that firms have been hesitant in hard wiring their board actions to pre-defined triggers and metrics, and have broadly aligned key decisions with the resolution crisis continuum to provide flexibility in undertaking requisite actions. The agencies on the other hand want firms to remove a degree of discretion and pre-commit to actions that would speed the resolution process. In particular, while the firms have made advancements in drafting subsidiary recapitalization agreements with defined capital, liquidity and market triggers, they have not yet linked them to specific actions by the management and/or the board.

In addition to hard-wiring triggers and metrics into the board governance playbooks, the guidance also underscores the importance of an escalation and communication strategy for both internal and external stakeholders, and addressing potential conflicts of interest, especially interlocking boards of directors between the holding company and the primary operating subsidiary (typically the bank or the broker dealer).

Our take on key ingredients to success
To address the spirit and the substance of the regulatory feedback, firms need to undertake additional activities to strengthen their governance framework for recovery and resolution. At a minimum, these steps should include:

- **Board Training:** Firms should put into place annual training for the directors of their MEs that reinforces their roles and responsibilities for recovery and resolution.
- **Board Composition:** Firms should also reevaluate their board composition across MEs to reduce conflicts of interests in recovery and resolution. Where outright mitigation is not an option, firms should identify predefined subcommittees or potential replacements, such that the boards are able to fulfill their fiduciary responsibilities for the MEs they represent.
- **Clarify Roles and Responsibilities:** When it comes to ME subsidiary governance, firms should enhance policies for resolution planning, such that there is clarity on the roles and responsibilities of subsidiary Boards in execution of the firms’ preferred resolution strategy, whilst still being able to satisfy local jurisdictional duties.
- **Align response protocols across resolution and other contingency plans:** Lastly, beyond calibrating triggers and metrics, and linking them to specific Board actions, firms would naturally need to align response protocols (including escalations, notifications, decision making, and monitoring and reporting) across different types of contingency plans, both financial (Contingency Funding Plan (CFP), Capital Contingency Plan (CCP), Recovery and Resolution, others) and operational (Business Continuity Plan (BCP)). In addition, they should also consider the development of an overarching crisis management framework that integrates response protocols to manage a single event or multiple combined disruptions, whether those disruptions originate externally or are specific to the firm. Leading crisis management frameworks will also build or enhance the firm’s capability to anticipate potential disruptions, train crisis leaders to respond to events, and certify teams for response through simulations and exercises.
Operational
Payment, Clearing and Settlement

The 2017 Guidance for Payment, Clearing, and Settlement (PCS) builds upon Principles and Practices included as part of SR Letter 14-1 for PCS activities. SR 14-1 requires development of Financial Market Utility (FMU) contingency arrangements or playbooks with the objective of preparing the firm to quickly respond to potential adverse actions taken by a FMU related to PCS activities. The 2017 Guidance reemphasizes the development of FMU playbooks related to continued access to key FMUs providing PCS services, in order to handle stress scenarios as defined by the FMUs or to support an orderly resolution.

For each FMU, the Guidance primarily focuses on the readiness to effectively respond to stress and ensure continued access, by utilizing required operational capabilities, provisioning adequate liquidity, and putting in place a well-defined communication/governance strategy to facilitate transparent FMU interactions. The key highlights include:

Operational Capabilities: Firms should outline a risk mitigation plan to maintain continued access to the PCS services (e.g., Netting, Clearing, and Custodial) availed by different MEs, and map how each service is used to support core business lines and critical operations, outline contingency arrangements, and acknowledge potential assumptions, dependencies or constraints that may impact the contingency arrangements. The firms should also describe their ability to furnish information (e.g. pre-positioned liquidity and financial reports) at required levels (e.g., ME) to facilitate ongoing communication with internal and external stakeholders.

Liquidity: Firms should describe their ability to readily meet potential increased financial obligations for each key FMU during stress. The firms should employ a well-defined stress methodology and process to estimate the increased obligations (e.g., increase in margin, guaranty/clearing fund, collateral), based on factors including current and expected volume and value data for each FMU, define mechanisms to meet increased obligations using reserves or liquidity arrangements positioned at different levels (e.g., ME, parent), and determine adequacy of liquidity arrangements. The methodology should also consider scenarios including, but not limited to, pre-positioning additional liquidity at FMUs, limiting intraday credit provisions to clients, and requiring clients to pre-fund settlement activity.

Communication / Governance Strategy: Firms should describe their communication strategy to facilitate continued and consistent communication (e.g. financial information) with internal and external stakeholders including FMUs, counterparties, and clients. Firms should also describe their governance framework and mechanisms to respond to FMU adverse actions related to financial, operational, legal, and regulatory requirements within appropriate turnaround times. The governance framework should define role of senior management to ensure required action(s) are taken promptly, particularly in scenarios with significant risk such as restrictions on specific activities, and membership suspension or termination by an FMU. The framework should address internal controls to ensure proposed recapitalization and funding, and quality control and accuracy regarding plan submissions.

Net new requirements from 2017 Guidance for PCS Activities:
(1) Firms should quantify and explain how they would satisfy their obligations and exposures related to PCS activities, using volume and value data for each FMU; (2) firms’ analysis of contingency arrangements should include pre-positioning of additional liquidity at FMUs, limiting intraday credit provisions to clients, and requiring clients to pre-fund settlement activity; and (3) firms should provide clients with transparency into the potential impacts from implementation of contingency arrangements and consider additional actions where appropriate.

Our take on the 2017 Guidance and expected capabilities
The affected financial institutions will have to address shortcomings and deficiencies in their respective plan submissions. However, many firms may face the following key challenges to comply with existing and new guidelines in relation to PCS activities:

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5 The Guidance suggests usage of volume and value data for each FMU involved in cash, securities, and derivatives markets to identify its key FMUs and describe this analysis in the plan.
Liquidity: In general, most firms position liquidity at different levels including ME, parent entity, and specific reserves to meet increased requirements (e.g., margin requirements). However, based on the new guidelines, firms may have to invest a significant amount of effort as part of their contingency arrangement discussions to address pre-positioning of additional liquidity for each FMU, considering and applying limits for intraday credit provisions to clients and managing clients to pre-fund settlement activity.

Management Information System (MIS) Data Availability: Firms may not have a mature MIS capability to readily and reliably retrieve latest or historical data related to PCS activities, for a given ME or FMU. The data required may include, but are not limited to:

- Volume and value data for each FMU involved in cash, securities, and derivatives markets, and
- Dependencies and mappings between core business lines and critical operations supported by a given entity with direct or indirect access to PCS services provided by a given FMU

This, coupled with the new guidance that firms should complete MIS infrastructure projects by July 2017, will put increased pressure on financial institutions to leverage already limited resources (e.g., business and technology personnel) to execute MIS projects in addition to other regulatory and business mandates, and that too within a short timeframe.

Stakeholder Accountability and Availability: With complex and often overlapping organizational structures prevalent across most major financial institutions, many firms will struggle to clearly delineate responsibilities between stakeholder groups at different levels (e.g., MEs, core business lines, group functions such as operations, treasury, legal) to own specific actions in order to effectively respond to adverse actions taken by the FMUs. Furthermore, even after stakeholders have been identified and responsibilities clearly delineated, prioritizing their time to periodically refresh the FMU playbooks is a major challenge given the fact that those stakeholders are likely having to manage multiple competing regulatory and business priorities.

Quality of Regulatory Submissions: Many firms also face an ongoing challenge to ensure that their plan submissions are complete, accurate and consistent. This is primarily due to the lack of an established structure for the submissions, coupled with the lack of guidance in terms of information to be covered, and the level of detail that needs to be presented in the plan submission. Additionally, most financial institutions do not have a single golden source that can be tapped to provide the full set of applicable adverse actions across the FMUs. Also, involvement of multiple stakeholders to update and validate different sections of the same plan submission without clearly established guidelines and direction from a central committee further accentuates the problem.

Our take on key ingredients to success
Firms should consider adopting the following key leading practices to help them overcome the aforementioned challenges while preparing their planned submissions based on new and existing guidelines:

Integrated Governance Framework: Good governance is the cornerstone of a firm’s enterprise-wide response to the adverse actions that may be taken by the FMUs. It enables the firm to more swiftly and effectively respond to regulatory or FMU actions. So, firms should establish and operationalize a well-defined governance framework by adopting the following key guiding principles:

- Aim for an integrated governance structure across the business divisions with authority to make quick and effective decisions
- Define and enforce clearly delineated roles and responsibilities across stakeholder groups including overseeing of responses for adverse actions
- Define escalation protocols for promptly addressing any issues
- Adopt a coordinated response strategy where a central response committee handles escalations, facilitates group-wide interactions and decision-making, and manages interdependencies between stakeholder groups. The central response committee should be led by a business/operations/treasury stakeholder that has the right level of seniority within the firm and that leader would be the single point of communication with the FMUs until the stress scenario is appropriately addressed.
Centralized MIS Data Repository: Firms should have a centralized MIS data repository to facilitate quick access to information related to PCS activities including, but not limited to:

- Mapping of FMU memberships and associated services to legal entities (direct/indirect), business lines and critical operations
- Volume and value data for each FMU involved in cash, securities, and derivatives markets
- Full set of adverse actions across the FMUs
- Primary contacts to handle the communication with each FMU during normal business and stress scenarios

Continuity and Contingency Arrangements: Firms should build and periodically maintain continuity and contingency arrangements for potential adverse actions that may be taken by each of the key\(^6\) FMUs. The arrangements should address concerns and ensure continuity by outlining the operational capabilities, liquidity positioning, legal contracts and governance mechanisms available to handle a stress or resolution event. The arrangements include, but are not limited to:

- Identification of owners accountable to handle response to specific adverse actions taken by a FMU or counterparty
- Quantification and explanation of adequacy of liquidity arrangements to meet increased obligations and exposures determined based on current and expected business volumes,
- Acknowledgement restrictions such as asymmetric unwinding of positions, ability to access bilateral over-the-counter (OTC) markets, and ability of clients to use other existing relationships for doing business
- Categorization of impact to house, house-affiliates and client business, as applicable
- Performing a thorough diligence and review of all information stated as part of continuity and contingency arrangements and ensuring consistency of information across sections

\(^6\) The Guidance suggests usage of volume and value data for each FMU involved in cash, securities, and derivatives markets to identify its key FMUs and describe this analysis in the plan.
Collateral

In the 2017 Guidance, the agencies noted that firms should “have capabilities … related to managing, identifying, and valuing the collateral that it receives from and posts to external parties and its affiliates.” Specifically, the firm should be able to provide aggregate statistics for all qualified financial contracts concerning cross-default clauses, downgrade triggers, and other key collateral-related contract terms across contract types, business lines, legal entities, and jurisdictions.

To ensure better tracking, on at least a t+1 basis, the firm should be able to track collateral pledged and received at the Committee on Uniform Securities Identification Procedures (CUSIP) level and be able to track and report on inter-branch collateral pledged and received. When pledging collateral to central counterparties, the firm should be able to identify the corresponding CUSIP and asset-level information by legal entity on at least a t+1 basis. The firms should have “robust risk measurements for cross-entity and cross-contract netting” that considers where collateral is held and pledged. Firms are also required to have a specific policy that explains the rationale of inter-branch pledges and a more comprehensive collateral management policy that outlines how the firm as a whole approaches collateral and serves as a single source for governance.

Prior to the feedback, the expectations outlined by the FRB in SR-14-1 for collateral management underscored the need for effective processes for managing, identifying and valuing collateral. The supervisory letter highlighted the need for better identification of where collateral is located, documenting all netting and re-hypothecation arrangements, and heightened tracking of inter-affiliate collateral requirements. The guidance calls for a periodic review of International Swaps and Derivatives Association (ISDA) Master Agreements and Credit Support Annexes (CSAs) and a need to identify legal and operational differences in managing collateral within specific jurisdictions, agreement types, counterparty types, collateral types, or other distinguishing characteristics. The guidance for the 2017 plan further enhances the details outlined in SR 14-1.

Our take on the 2017 Guidance and expected capabilities

The financial downturn highlighted important issues surrounding overall collateral management practices, such as difficulty in aggregation, tracking, and reporting of collateral, lack of legal analysis for right to collateral by jurisdiction, inadequacy of internal liquidity sources to withstand bulk transfers/ asymmetric unwind of client trades, and risks arising from incorrect segregation and re-hypothecation of client collateral.

To address these issues, various regulatory reforms such as the Dodd-Frank Act, European Market Infrastructure Regulation (EMIR), Markets in Financial Instruments Directive (MiFID II), Basel III, and tri-party repo reform required firms to make significant investments to enhance their collateral management operational and technological capabilities. These reforms also contributed to spawning an eco-system of collateral management solutions including industry utilities and vendor solutions that firms are leveraging to further enhance in-house capabilities.

That said, significant strides are yet to be made to ensure any capabilities firms build out and pursue take into consideration, holistically, the complex web of regulatory requirements and business drivers (embedding cost of collateral considerations in the front office and treasury functions).

Our take on key ingredients to success

Know your jurisdiction and source: Firms should not only have capabilities to track collateral received and delivered, globally and by ME; but also be able to identify the jurisdiction where collateral is held and the source of each security (e.g., house positions, reverse repo, margin received, inter-affiliate), and subsequent use (e.g., repo, margin posted, box)

Invest in better MIS: Firms also need better collateral management information systems with a centralized repository of collateral agreements that can be searched for collateral terms and supported with documentation that includes limits on counterparty exposures and triggers on collateral usage, concentration limits, and haircuts.
Having transparency on the legal interpretation of collateral by agreement and jurisdiction, especially on prime brokerage is important and should be readily accessible via such a centralized repository. Margin requirements on uncleared OTC derivatives will also lead to increased usage of collateral, and with varying norms of acceptable collateral across jurisdictions, managing a centralized collateral management solution would be a legal documentation nightmare, if not implemented with these considerations in mind.

**Expand policies with specifics including roles and responsibilities:** Consistent with the expanded role of front office and the treasury functions in collateral management, firms should expand their collateral management policies to include limits on counterparty exposures and triggers on collateral usage, concentration limits, haircuts, and clearly defined roles and responsibilities of all parties involved.

Other initiatives to streamline global technology and operations (e.g., reducing collateral sub-ledger systems, streamlining margin processing across support centers) and preparation for phase-in of bilateral initial and variation margin exchange requirements for uncleared OTC derivatives commencing September 1, 2016, would naturally enhance firms’ collateral management operational capabilities.

**Improve collateral needs forecasts:** While firms forecast collateral needs across various stress scenarios during the CCAR and resolution planning processes, they need to build capabilities to be able to forecast collateral needs in times of stress on demand.
Management Information Systems

In the 2017 Guidance, the agencies noted five areas of focus for MIS, which are highlighted below. Firms should:

- Have the MIS capabilities to produce data on a legal entity basis
- Have controls to ensure data integrity and reliability
- Allocate technical and project management resources to complete MIS infrastructure projects by July 2017
- Institute a robust governance and accountability framework and executing detailed project plans, evaluating interdependencies and prioritization amongst MIS projects
- Perform a detailed analysis of the specific types, and frequency, of financial and risk data that would be required to execute the preferred resolution strategy

Our take on the 2017 Guidance and expected capabilities

Expectations of MIS capabilities are outlined in the FRB’s SR 14-1 by describing the capabilities an entity should have to access, analyze and report operational, risk and finance data around certain key areas, including collateral, liquidity and funding, payment clearing and settlement.

In recovery or resolution, a firm will need access to key systems and critical reports to monitor, manage, operate and/or resolve its businesses. In support of this need, a firm should:

- Have an understanding of its key systems, critical reports, and pertinent data underpinning the Resolution Plan; and
- Be able to produce timely, reliable and accurate data and reporting on a legal entity basis

Firms should develop the following core MIS capabilities:

- **Content/Coverage**: Align MIS to management’s decision making needs (in recovery and/or resolution). The information should provide adequate and timely content across critical management information topics, be available at the appropriate level: MEs, critical operations, and core business lines and the information and content should be searchable, and allow analysis by users. The guidance also highlights the importance of specific financial and risk data necessary to execute the selected resolution strategy.

- **Controls/Governance**: MIS should be reliable and the governance around required information and/or reports should be defined either through their enterprise data management policy and standards or similar framework. Data should be defined, well understood, aligned to golden sources (systems of record) and governance/accountability should be established over required report production, data/system ownership, and report ownership clearly defined with documented processes and procedures.

- **Accessibility**: Critical information is stored and is readily accessible. Firms should establish capabilities to identify and access key systems, critical reports and pertinent data by ME, critical operation, and core business line.

- **Frequency**: MIS should be available to support decision-making in a timely fashion, and firms should be capable of producing critical reports at a frequency required under a resolution.

Our take on key ingredients to success

Firms have made solid progress since the issuance of SR 14-1 and continue to assess and build capabilities to support the access and availability of critical information, including but not limited to operationalization of the contracts capabilities, enhancing reporting capabilities at the legal entity level, enhancing the methodology to
identify key reports, critical systems and critical personnel. Firms are also evaluating their current systems and infrastructure in order to build strategic capabilities across their organization.

A few considerations or best practices include:

- **Comprehensive Governance:** Establishing a comprehensive governance structure with a voice from the top to get the timely attention of MIS across the organization. To demonstrate a firm’s commitment to remediating capability gaps, regulators have emphasized the need for firms to have a robust governance framework and coordinated technical program management personnel.

- **Rationalize and leverage regulatory initiatives on MIS:** Assess regulatory guidance across MIS in a horizontal fashion along with RRP requirements for e.g., RDA (Risk Data Aggregation/BCBS 239 principles) and streamline approach/governance to meet multiple regulatory requirements in a unified way. Consider leveraging infrastructure by mapping technology, people and system capabilities with MIS needs across MEs, critical operations and critical business lines. Once mapped, identify redundancies and interconnectivity and rationalize and formalize the delivery of services through service level agreements to improve resilience and efficiencies.
Operational continuity remains a key focus of the agencies; the expectations outlined in the 2017 Guidance further emphasizes the need to ensure continuity of services for shared and outsourced services. In the 2017 Guidance, the agencies outline expectations for firms to identify and map critical services, integrate such mapping into legal entity rationalization efforts, and take steps to mitigate any operational continuity risks that may occur.

Overview of expectations

Identification and mapping of Shared Services: Firms are expected to identify all critical shared services (including staff, technical infrastructure, systems, intellectual property, and real estate) that support critical operations and maintain a mapping of these services that support core business lines and critical operations. As part of this mapping exercise, institutions are expected to identify which services are readily substitutable—along with a list of alternative service providers—and further document contingency strategies and/or arrangements for replacement of critical shared services.

Alignment with legal entity rationalization efforts: The shared services identification and mapping requirements are expected to be integrated into the institution’s legal entity rationalization efforts focused on reducing the complexity of the institution’s legal entity structure.

Mitigation of operational continuity risks: The agencies require institutions to have service level agreements (SLAs) in place to help mitigate operational continuity risks which may occur leading into resolution. SLAs should document services, pricing agreements, and appropriate provisions to prevent an auto-termination of service under certain resolution events and to ensure continuity of service in resolution.

Financial resiliency of internal shared service providers: In order to ensure the resiliency of internal shared service providers, institutions are required to pre-position sufficient working capital at internal service providers for the provision of critical services for the longer of either six months or as needed throughout the stabilization period in the institution’s preferred resolution strategy.

Critical Outsourced Services (i.e., external providers): Firms must identify critical outsourced services supporting critical operations and determine if such critical outsourced services can be substituted in resolution. In cases where outsourced services are not readily substitutable, existing service agreements with external providers are expected to include resolution resilient language to avoid any service disruptions through the resolution period.

Our take on the 2017 Guidance and expected capabilities

The first required step on the path to operational continuity and meeting the overall expectations of the 2017 Guidance is to identify the population of critical services that support critical operations. Firms are required to identify all critical services and how/where they support critical operations before assessing operational continuity risks and integrating broader legal entity rationalization efforts.

Once a near-term solution is completed for the initial mapping of shared services, a challenging aspect of the guidance includes the installation of long-term strategic technology solution for supporting a mature and repeatable shared services mapping process that is integrated with the firms’ existing infrastructure.

“Re-papering” agreements with non-substitutable external service providers may present challenges associated with negotiating service agreements including resolution resilient contract clauses and the requisite pricing for these uncertain events. It is a benefit that the institutions are not alone; peer institutions are in the same boat and are negotiating with external service providers to include resolution contract clauses. Some institutions may be further along than others in their negotiations with external service providers, but external service providers should not be surprised with these requests from institutions.

Our take on key ingredients to success

Continuity of critical services only begins with the identification of critical shared services: Firms will need to not only provide the mapping of shared services, but also develop a point of view on how to mitigate operational continuity risks. A path to credibility should include the ability to ensure continuity of services in resolution. The combination of establishing SLAs and the development of operational continuity playbooks can assist in ensuring of the continuity of services across the resolution continuum.

Shared Services Governance to support a sustainable process: A strong governance structure is needed to develop a long-term strategic solution for shared service mapping, and to integrate the analysis into the organization’s legal entity rationalization approach and overall resolution strategy.
The agencies have recommended that a bankruptcy playbook be drafted to address potential legal obstacles related to emergency motions. The agencies also recommend that the playbook include sample emergency motions and draft documents to facilitate the continuation of governance post-bankruptcy. The expectation would be that the legal arm of the firm and outside legal counsel would own the elements of execution of this playbook and any obstacles that arise from the emergency motions that would need to be filed. In the 2017 Guidance, the agencies provide for collaboration amongst the firms and other organizations to not only come to identify common legal challenges but also to identify available mitigants.

Our take on the 2017 Guidance and expected capabilities

Given the complexity of the firms and the nuances of the bankruptcy process, firms should be working with outside legal counsel that specializes in bankruptcy with additional support in key areas such as derivatives and bankruptcy regulations in different countries. The “First Day Motions” will be of critical importance to set the stage for how the resolution strategy will unfold for key areas of the plan. For example, motions could be filed to consolidate Chapter 11 cases if the parent and some subsidiaries are all part of Chapter 11 proceedings. Other filings, such a motion to waive filing of creditor lists and procedures for notifying creditors of the Chapter 11 filing, are necessary to begin the broader notification of the bankruptcy of the firm. The motion regarding derivatives will address the firm’s ability to enter into, continue performance under and pledge collateral under hedging/swap/derivatives contracts.

There will also be motions related to payment of certain services (i.e., critical vendors), assuming business specific agreements, and continue to utilize certain systems (i.e., cash management). Motions will also be filed to implement the HR retention plan which would include payment of pre-petition wages, salaries, benefits and other compensation, maintenance of benefit programs and other obligations, and allow employees to proceed with outstanding workers’ compensation claims. And firms will also file a motion to retain certain professionals as needed to execute the resolution strategy.

Our take on key ingredients to success

The legal department of the firms and outside counsel should develop a plan for how they would consult with US and foreign regulators to determine what regulatory applications would be required under the firm’s resolution plan. These regulatory applications may be filed during the runway period and cover actions related to the formation of the new firm under the resolution strategy (e.g., Single Point of Entry (SPOE)). For example, the new organization would need to file an application to be a bank holding company and file the election to be financial holding company. There may be applications to be filed with FINRA and the SEC depending on the firm’s plan for existing broker/dealers and whether there will be significant changes in resolution.

For foreign jurisdictions, firms should determine whether they need to file change of control applications, change of management applications, or additional notifications required because of insolvency or other regulatory requirements, and whether they need to make antitrust filings.

The complexity in executing the resolution plan cannot be underestimated. There are filings with the bankruptcy court; communications with regulators, clients, employees, vendors and many others; maintenance of business and operations as resolution plan is executed; and assigning the appropriate resources to handle issues that arise as the resolution plan continues to unfold.
Legal Entity Rationalization and Separability

The 2017 Guidance focuses on the definition and specificity of Legal Entity Rationalization (LER) criteria and its ability to guide management to use them meaningfully to improve resolvability. The ability to create a legal structure that can facilitate separation and sale of material legal entities that support business lines while providing some level of flexibility in the resolution strategy based on the failure scenario is a cornerstone for a successful plan. The agencies see the need for institutions to consider recovery and resolution planning into BAU decisions around aligning business lines to legal entities. BAU processes are expected to include resolution planning criteria that are considered when new processes, products, or entities are established or removed. Further, the agencies expect institutions to prepare separability analyses. These separability analyses are akin to traditional mergers and acquisitions (M&A) exercises and come with the additional requirement of building data rooms to house all the necessary documentation. The difference is that these plans are not implemented for business purposes and will need to have optionality to reflect stress scenarios with realistic limiting factors on available resources to fund operations, the limited runway to execute a transaction, and the limited market to sell entities. In many cases, overall franchise value will be adversely impacted; however, the key is to have resulting transactions that result in less systemic risk.

Our take on the 2017 Guidance and expected capabilities

In many large companies, the number of redundant legal entities can be overwhelming, and considerable internal resources (and costs) are potentially devoted to maintaining the excess entities. Simplifying the legal entity structure can, however, be a challenging undertaking in itself, and some companies have avoided it because of the perceived price tag or additional cost to current business processes. The feedback from the regulators makes it clear that they want banks to become less complex. Prioritizing resolvability considerations may lead to inefficiencies in normal operating conditions. However, institutions will need to strike a better balance when defining and applying their LER criteria in order to demonstrate to the agencies that strategic decisions taken relating to corporate structures maximizes resolvability.

Traditionally, firms addressed LER as an exercise in cost reduction, identification of efficiencies and tax benefits. While the focus shifts to address the agencies concern on resolvability, the core components of LER analysis will primarily stay the same. The added lens will be focused on evaluating the risk to the enterprise and its systemic risk for each of these entities in a resolution scenario. Firms will also be expected to evaluate whether certain businesses poses additional complications to a resolution strategy to the point where that business no longer makes sense for that firm.

The 2017 Guidance further requires that firms establish a
Carve-Out Financial Statements and Considerations
In conjunction with the other requirements for RRP and SR 14-1, the ability to generate the carve-out financial statements (financial statements of a business “carved-out” of a larger business) can present challenges for firms. The agencies are requiring that these analyses be refreshed annually but given that a resolution can occur at any time, firms have to be prepared to produce refreshed versions of this information as needed.

Carve-out financial statements can be a complex undertaking since the discrete operations to be sold or transferred in resolution may not have stand-alone financials and may be part of a consolidated business or group. If the discrete business to be sold or transferred in resolution does not have stand-alone financial statements, then the assets, liabilities, revenue and costs associated with the discrete business must be carefully identified and carved-out to create a stand-alone financial view of the business. It is important to consider whether the business being carved-out is a going concern or a collection of assets (e.g., securities or loan portfolio); the strategy can have a material effect on the carve-out accounting and preparation.

Data rooms are common practice in M&A and are either physical locations or virtual sites used to store confidential information about a target company. Data rooms typically store a comprehensive array of commercial, financial, legal and regulatory information on a target business. Compiling a data room can be time consuming and expensive for large institutions with extensive data sets.

Unlike a typical M&A transaction where a data room is created and discontinued once a transaction is completed, the 2017 Guidance requires that data rooms be created and refreshed at least annually. This requires careful planning to comply with the guidance and to avoid inefficiency and excessive cost. Below highlights design principles be considered in organizing a data room:

- Flexibility to accommodate legal entity and business changes
- Comprehensive enough to withstand regulatory scrutiny
- Leverage technology to drive cost-effectiveness
- Repeatable process with clear roles, responsibilities and sound governance
- Designed to be efficiently and cost-effectively refreshed on an annual basis
- Establish a governance process to ensure accuracy, completeness and timeliness of data

Our take on key ingredients for success
In our experience, LER analyses can result in emotional responses as the outcomes generally result in some type of shrinkage which affects the people of an organization. Resolution planning efforts performed to date (e.g., identification of financial and interconnectedness) should help understand desired outcomes of LER. There are many factors that come into play when determining the “right” number of legal entities. Some key ingredients of implementing a LER criteria in your organization include:

- LER criteria and desired outcomes should be clearly defined: Given that the agencies are expecting firms to make progress on LER, institutions should clearly define expectations and outcomes throughout the lifecycle of the LER process to keep management and the agencies informed along the journey
- LER should be built into a BAU process, not just for RRP purposes: The pace at which banks have grown has resulted in very large, complex organizations where the cost does not always support the number of legal entities
- Separability analyses should be viewed through an M&A lens: Companies that have been acquisitive in the recent past and have not engaged in a focused entity simplification are very likely too complex, and could realize savings and risk mitigation if they slimmed down. The analyses should consider alignment with the overall business strategy and incorporate a future state that improves resolvability and accurately reflects the needs of the organization
Derivatives and Trading Activities

In the 2017 Guidance, the FDIC and FRB noted expectations within five areas for derivatives and trading:*

- **Data/Information:** Availability of Risk data associated with derivatives trading, including on a legal entity basis, by broker-dealers, banks, and other derivatives trading entities.
- **Booking model:** Well developed booking model with capabilities to track and monitor market, credit, and liquidity risk transfers between legal entities.
- **Transfer of Prime Brokerage accounts:** Capability to transfer accounts to peers taking into account operational challenges (such as insufficient staffing) to facilitate the orderly transfer.
- **Development of additional Playbooks (i.e., rating agency and communication playbooks):**
  - **Rating agency playbook:** to facilitate the stabilization of each trading entity, following the bankruptcy filing of the parent company.
  - **Communication playbook:** to ensure clients, regulators, key FMUs, and clearing and settlement agent banks understand what is happening throughout resolution.
- **Development of additional wind-down analysis:**
  - **Passive Wind-Down Analysis (investment-grade ratings not maintained):**
  - Estimate financial resources to support wind-down.
  - Incorporate into estimates the magnitude and nature of basis risk resulting from only hedging with exchange-traded derivatives (ETDs) and cleared derivatives.
  - Identify and analyze the risk profile of the rump assets (i.e., the residual portfolio).
  - **Active Wind-Down Analysis:**
  - Include data and narrative describing at least one pathway for segmenting, packaging, and winding down the derivatives portfolio considering the

i) Nature, concentration, maturity, and liquidity of derivatives positions
ii) Proportion of centrally-cleared versus uncleared derivatives
iii) Anticipated size, composition, and complexity of the portfolio at the end of the wind-down period (i.e., the residual portfolio)

- Identify mitigants to challenges with novating less liquid, longer-dated derivatives; and obtaining timely consents from counterparties and potential acquirers (step-in banks).
- Identify and analyze the systemic risk profile of the portfolio that remains at the end of the active wind-down period (i.e., the residual portfolio), including its size, composition, complexity, and potential counterparties.

**Our take on the 2017 Guidance and expected capabilities**

Firms are required to demonstrate capabilities to calculate exposures between affiliates and with counterparties to assess risks associated with derivatives trading. This has always been an area of focus, but through the 2017 Guidance, the agencies have provided data fields and the format of data required.

Booking model strategies have been typically driven by client/counterparty domicile and preferences, location of risk management hubs, market access and any capital efficiencies gained. Regulators are now keen to understand how risks are originated, where they reside, how they are managed and whether firms are adequately taking into account how these practices impede resolvability. As such, it is important that firms articulate their booking strategies clearly and where impediments to resolvability risks exist, they must remove or mitigate them.

Another priority for the regulators is return or transfer of customer and prime brokerage client assets to preserve financial stability. Firms are required to demonstrate operational capacity to process an increased volume of...

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*These requirements are only applicable to the four dealer firms as identified in the 2017 Guidance.*
accounts transfers in a swift and orderly manner.
Consistent with prior feedback, most firms with significant client trading operations have already developed detailed operational bulk account transfer contingency plans.

While some firms have incorporated rating agency behavior in their assumptions for runway and resolution, as well as in their communication strategy, they are expected to develop detailed playbooks outlining the strategy and the plan to maintain, reestablish, or improve ratings to investment grade or equivalent for each trading entity.

The agencies have repeatedly emphasized robust solvent wind-down analysis, and in the 2017 Guidance the agencies reiterated considerations for active and passive solvent wind-down analysis, with the added dimension of detailed quantitative estimates related to derivatives portfolios. This is consistent with UK Prudential Regulatory Authority (PRA) guidance outlined in Supervisory Statement SS19/138 (Solvent wind down analysis). Firms which have significant trading operations in UK have already developed capabilities and processes in the UK to furnish this information, and they can look to leverage those capabilities to fulfill the expectations of the US regulators.

Firms are also expected to provide realistic assumptions related to liquidity, capital, operations and technology to support trading businesses across the resolution continuum.

Our take on key ingredients to success
Continue to rationalize trading activities for improved resolvability: As a result of other regulatory reforms such as Title VII of the Dodd-Frank Act, Basel III, MiFID II, firms have invested in multilateral portfolio compression, compaction, and rebalancing techniques, in conjunction with vendors to reduce the volume of outstanding OTC derivatives. Firms should continue to rationalize and reduce inter-affiliate derivative, and remote booking trading activities.

Use rating agency methodologies as a guide in playbooks: Each of the major rating agencies have incorporated specifics related to resolution scenario into their rating methodologies.9 Firms should look to develop their rating agency playbooks based on these methodologies, and clearly outline actions to re-establish credit ratings, including how to enter into contractual arrangements (either ex-ante or post-resolution) and satisfy the due diligence requirements of the agencies. The industry should consider an approach similar to the initiative led by The Clearing House for drafting FMU playbooks. It is important to obtain clarity, in working with the rating agencies, on how such a process would work post-resolution.

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Public Section

All eight G-SIBs are required to submit a public section by October 1, 2016 as part of the institution’s 2016 Resolution Plan Submission. With more specifics from regulators on deficiencies and shortcomings this year, the 2016 Public sections are even more important than in the past and provide an opportunity for institutions to specifically let the public know how they are addressing those issues. Firms may also let the public know more broadly about the significant progress made in improving resolvability in the 15 months since the submission of 2015 plans. For plans with identified deficiencies, the greatest focus will be on the actions taken since 2015, and why the firm believes the actions remediate the identified deficiencies. For plans with identified shortcomings, there will be an added emphasis on the institution’s path to address shortcomings by July 2017, before shortcomings have the ability to become deficiencies.

In August 2014 and in February 2015, the agencies also provided guidance on Public Sections of the Resolution Plans that was fairly prescriptive, including key information on the resolution strategy and material legal entities among other elements.

Public Section expectations for July 2017

Further emphasizing the need for increased public disclosure, the 2017 Guidance outlines expectations for the public section across major themes. Generally, the guidance is consistent with the expectations and tone outlined in previous issued resolution planning guidance communications emphasizing the importance of public disclosure.

- **Description of MEs**: explain the rationale for designating MEs
- **ME interconnectedness**: enhanced description of financial and operational interconnectedness and how the interconnectedness may impact the institution’s resolution strategy
- **Resolution Strategy**: further explanation of how the institution’s strategy serves for continuity, transfer or wind-down of the entity and its critical operations; additional detail of what the institution looks like upon completion of the resolution process
- **Actions to improve resolvability**: further explanation of the steps institutions are taking to improve resolvability under the US Bankruptcy Code
- **Financial Resources**: discussion of the institutions liquidity resources and loss absorbing capacity
- **Remediation of agency identified deficiencies and shortcomings**: explanation of how the institution has addressed, or actions taken to address, deficiencies and shortcomings identified by the agencies

**Our take on key ingredients to success**

The regulators have communicated that, by July 2017, all shortcomings and deficiencies must be remediated. Thus, the July 2017 public section should emphasize remediation actions taken and how the organization’s resolution strategy is executable. Further, the 2017 public section will need to advance the story and expectations institutions outline in the 2016 resolution plans.

- **Consider going above and beyond what’s required**: Firms should consider exceeding the minimum regulatory requirements with respect to their public section disclosures, which should show the agencies that they take seriously the requirement to submit a robust public section
- **Demonstrate resolvability to the public**: In order to demonstrate to the public and the market that they have taken steps to address all deficiencies and shortcomings identified in their 2015 resolution plans, firms should consider including specific milestones in their public sections. By clearly outlining both their progress to date and planned future actions, firms can underscore their commitment to enhancing resolvability and improve the transparency of the resolution planning process
Conclusion

In August 2014, when the agencies issued joint feedback letters to institutions\(^\text{10}\) identifying shortcomings in the 2013 plans and additional information to be included in their 2015 plans, the theme for institutions was “get ready... and set...” for the wave of US Resolution Planning. The strongly worded public statements from the agencies in 2014 was seen as the beginning of the “drawing a line in the sand;” telling institutions they have until the 2015 submission to demonstrate concrete plans that simplify legal entity structure, remediate shortcomings, and improve resolvability. Up to this point, the feedback had been less specific and less public. As the agencies have learned more about the plans that were submitted and have progressed in getting closer to being able to more specifically identify what is needed to comply with the requirements of the rule, the expectations are increasing.

Fast forward to 2016: the 2015 resolution plan designations have been disclosed and further expectations have been set for 2017, and the theme for institutions is “Go!” or at least demonstrate more meaningful progress in specifically identified areas. US G-SIBs are entering unchartered territory with respect to their resolution planning efforts, specifically the five firms that were found to have deficiencies in their plans. Although these institutions have an opportunity to remediate the deficiencies in their plans, failure to submit credible plans by October 2016 would allow the FRB and FDIC to impose heightened prudential standards (i.e., more stringent risk-based or leverage capital standards, higher liquidity requirements, or other operating restrictions). Further, if a firm does not remediate the deficiency within two years of the imposition of such a requirement, the agencies, in consultation with the FSOC, retain the authority to order the company to divest certain assets or operations to facilitate an orderly resolution. The result is that institutions will need to move quickly to ride on the path to credibility. Not only will they need to provide a public version of their response, they will need to be able to disclose to investors the implication of the feedback on their financial performance. This transparency provides further urgency for institutions to demonstrate that they can both comply with the requirements of the rule and maintain a viable business model. In addition, firms should pay close attention to related regulations (e.g., uncleared margin rules) that will come into effect this year or in the near future, which will have a significant impact on the firms’ resolution planning efforts.

The institutions whose plans were deemed not credible will need to continue to make progress on addressing shortcomings to reduce the risk of entering the penalty box and having their 2017 plan deemed not credible. This will mean quickly understanding what can be accomplished by the October deadline, then understanding what can realistically be accomplished by July of 2017 and ultimately being able to demonstrate a viable strategy that goes beyond 2017 and shows that the resolution process is something that will evolve both with business changes and increasing regulatory expectations. Communication will be a critical factor in determining success. This means both internally across all lines of defense and externally with regulators. Regardless of the feedback that was received in the form of deficiencies and shortcomings, all institutions have substantial work to be performed to achieve a credible determination.

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Considerations Going Forward: Outlook toward July 2017

**Institutions need to remain responsive to feedback and guidance:** One of the seven areas the agencies evaluated to make determinations and identify required actions includes how an institution complies with prior feedback and takes feedback in account in developing future resolution plans. Expectations are set and failure to remain responsive and comply with feedback and guidance may cause your plan to be deemed not credible.

**The progress has not stopped since the 2015 Plan:** Institutions will need to evaluate progress made since the 2015 resolution plan against identified shortcomings and deficiencies and new expectations outlined in the 2017 Guidance. For ex-ante projects that are in place and that tie to shortcomings and/or deficiencies, institutions should reevaluate baseline projects to determine impact to timing and scope.

**Countdown to October begins, but the race does not end until July 2017:** The race to October 1, 2016 is on to address identified deficiencies; organizations need to quickly understand the effort required and prioritize the remediation of deficiencies. However, the 2017 Guidance should not be placed on the back burner post-October 2016.

**Regulatory guidance and expectations should not be viewed in silos:** Synergies exist while designing and implementing capabilities across regulations in the agencies’ “tool-box” (e.g., TLAC and RRP). Institutions will need to further think efficiently and strategically to allocate resources and define capabilities as regulatory costs continue to rise and the same senior stakeholders are being engaged to assess, design, and implement expected capabilities.

**Internal audit to play a larger role:** The agencies will not serve as quality assurers. There needs to be strong governance across the plan and the role of internal audit will need to further expand to ensure there is consistency across the plan and implements the institution’s preferred resolution strategy.
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