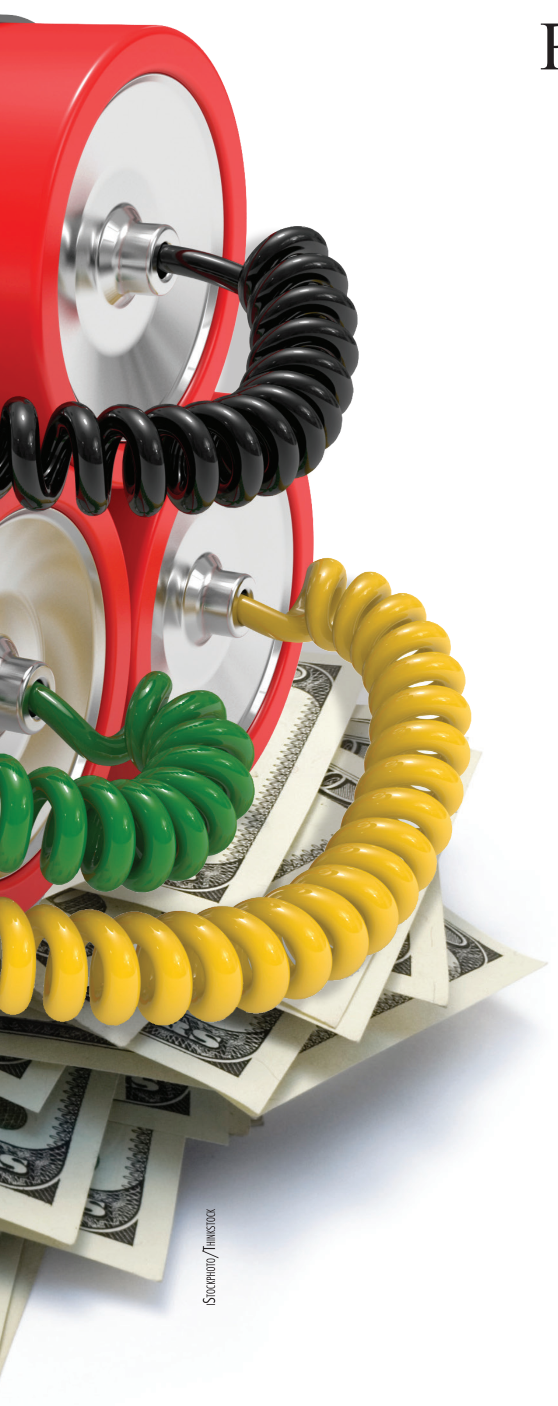
Resolve

to Make It Better

Lessons Learned in the Resolution Planning Process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The sudden fall of Lehman Brothers in 2008 underscored many lessons, one of which was that a major financial institution could falter and collapse within an extraordinarily short period of time. This lesson was reiterated with the sudden collapse, over a single weekend, of MF Global in the autumn of 2011.

> The reality is that the failure of a financial institution can occur quickly and, absent advance planning, leave little or no opportunity for strategic thinking and optimal execution.

In an ideal world, a faltering institution would be resolved over a reasonable period of time, during which the company and regulators could make informed decisions about the optimal strategy for winding down the institution and minimizing contagion effects. The reality, however, is that the failure of a financial institution can occur quickly and, absent advance planning, leave little or no opportunity for strategic thinking and optimal execution.

As a result, legislators and prudential supervisors in the United States and other advanced economies are instituting resolution planning requirements for systemically important financial institutions (SIFIs). Essentially, large financial institutions are required to formulate contingency plans in advance of financial distress, without the pressures inherent in real-time decision making. This process is a huge undertaking. For financial institutions operating in multiple countries, it is further complicated by the differences between each nation's resolution planning requirements.

While a recovery plan assumes some degree of distress, a resolution plan assumes severe distress or outright failure.

Nevertheless, timely planning and insightful thought leadership *pre*-crisis can minimize costs and disruptions *post*-crisis.

Nine of the world's largest financial institutions submitted resolution plans in the United States at the end of June 2012. More than 100 additional institutions face similar requirements before the end of 2013. Now that the first round of submissions is over, this article shares some of the lessons learned from the experience.

Overview of Resolution and Recovery Planning

Legal Framework

In July 2010, Congress enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act. The Dodd-Frank Act requires SIFIs to prepare resolution plans. The primary regulators of the resolution planning process are the Federal Deposit Insurance Corporation (FDIC) and the Board of Governors of the Federal Reserve System (the Fed).

Under the Dodd-Frank Act, a resolution plan must provide detailed factual information about the company and explain how, in the company's view, a situation of insurmountable financial distress could be resolved without extraordinary government support. The plan's objective is to mitigate the risk to the stability of the U.S. financial system that the company's failure would pose.

Resolution plans are driven in part by the reality that the failure of a financial institution can occur suddenly and that strategic thinking and optimal planning may not be feasible in times of distress. Resolution plans mandate that institutions formulate contingency plans in advance of financial distress, without the pressures inherent in real-time decision making.

Resolution planning focuses on three concepts: core business lines, critical operations, and material entities. Core business lines are those lines of business whose failure would cause a material loss of revenue or franchise value. Critical operations are operations whose failure would result in systemic risk to the U.S. financial system. Material entities are legal entities that hold core business lines or critical operations or that provide support necessary for their continued functioning. A resolution plan addresses the resolution of an institution as a whole, as well as the specific resolution of each core business line, critical operation, and material entity.

In the United States, many of the large financial institutions were also required to submit a recovery plan, which is distinct from a resolution plan. While a recovery plan assumes some degree of distress, a resolution plan assumes severe distress or outright failure. And whereas a recovery plan explains how the company could be rehabilitated, a resolution plan explains how the company could be sold, liquidated, or otherwise wound down. Institutions can, however, leverage resources and materials from their recovery planning efforts to aid in preparing a resolution plan.

The Players in Resolution Planning

Resolution planning involves a number of personnel, from within and outside the firm, who form the following groups:

- *The Resolution Plan Team.* The project managers of the resolution planning process and their team run the process. The resolution plan (RP) team serves as an information aggregator, project driver, and thought leader. The team typically includes senior executives from legal, treasury, finance, and risk management, as well as project managers, outside advisors, and data compilers. In particular, the RP team should also include individuals who understand the workings of the company's business lines, legal entities, risk management systems, methods of financing and cash management, operations, vendor agreements, service-level agreements (if any), and information dependencies between and among each of these areas. The RP team is primarily responsible for project management—including regular meetings with regulators, supervising the information-gathering and mapping processes, and drafting the plan.
- *The Front Office.* The front-office businesspeople are essential contributors to the company's resolution planning because they have the greatest knowledge of how the institution's business lines operate, how they interact

with other business lines, and how they connect with the company's critical operations. Front-office people understand and can explain the practical effects that trading regulations and other legal rules have on their businesses, which helps the RP team explain in the strategic analysis component of the plan what the practical effects of certain resolution actions would be. Front-office people, however, are trained to manage their businesses for success, not for failure; thus, it is important that they fully appreciate the working assumption that the company has already failed. Because they are familiar with each core business line and critical operation, front-office people possess particular institutional knowledge that is at the crux of the plan—and the key to designing resolution strategies, identifying barriers or obstacles to resolution, and developing assumptions.

- *The Regulators.* The FDIC, the Fed, and potentially other regulators will engage in dialogue with the RP team as the plan is being developed. Typically, the regulators will require a series of meetings with the team. In addition, the regulators will have staff on site to facilitate interaction throughout the process.

Public versus Private Sections

A resolution plan is divided into two main sections: a public section and a private section. The public section contains a general overview of the financial institution and its businesses, including the firm's material entities, core business lines, and critical operations. It also explains the concepts and strategies underlying the firm's resolution approach. The public section is, as the name suggests, available for public review.

The private section, which is confidential, comprises nine subsections. These include an executive summary, a strategic analysis of resolution options, a description of existing corporate governance mechanisms, an outline of the organizational structure, and a description of management information systems. The strategic analysis is the most complex of these subsections and contains the substantive work of the resolution plan.

Strategic Analysis

The strategic analysis subsection has eight parts: 1) key assumptions, 2) resolution strategy at the material entity level, 3) resolution strategy at the core business line level, 4) resolution strategy at the critical operation level, 5) applicable legal regimes mapped to material entities, 6) the overall resolution strategy and approach, 7) supporting analysis for the resolution of each material entity, and 8) key resolution obstacles.

Non-U.S.-based companies must also include information regarding how the U.S. resolution strategy fits into the overall resolution approach for the company as a global enterprise. They must also explain key interdependencies between U.S. and non-U.S. material entities, core business lines, and critical operations.

The strategic analysis subsection—which involves the greatest amount of input and dialogue between the RP team, front office, and regulators—requires an independent, detailed resolution strategy for each material entity, core business line, and critical operation, plus an explanation of how each resolution strategy fits into the company's overall resolution approach.

Data Aggregation and Warehousing

As noted above, other required elements of the resolution plan include a detailed description of existing corporate governance mechanisms, an outline of the organizational structure, and a description of management information systems. In many respects, at the first-submission stage, resolution planning is more physically than intellectually challenging. As the scenarios change, the process becomes more intellectually challenging with subsequent submissions. For the first submission, an important part of the process is to implement an efficient way to aggregate and warehouse the required data. This effort will streamline the data compilation for future submissions.

To ensure a smooth process and seamless product, a small core team should be assembled at the outset to develop the work plan and manage the entire process.

The Basics of 'How To'

The discussion immediately below covers the basics of how to organize a process for resolution planning. (The section that follows presents a more detailed discussion.) Organization, planning, and process cannot be stressed enough. They are the keys to running a cost-effective and time-efficient process that culminates in a credible resolution plan.

Core Team

To ensure a smooth process and seamless product, a small core team should be assembled at the outset to develop the work plan and manage the entire process, from concept and data collection to drafting and completion. At a minimum, this team should include one or more of the following: 1) someone with extensive knowledge of the company's operations and organization, including internal relationships that facilitate access to people and data; 2) internal and/or external advisors with expertise in resolution (insolvency) and regulatory matters; and 3) internal and/or external resources with data management skills. The core team will be the heart of the RP team, but the RP team will include many others as well.

Senior Management Visibility

The core team must have the imprimatur of senior management so that everyone in the company understands the importance of providing timely and complete access to people and data. For most companies, the individuals called upon to provide input and information will already be working at capacity and have many demands on their time. Without visible support from senior management, the resolution planning process will be a low priority for these individuals.

Work Plan

Before the first internal interview is scheduled, the RP team should develop a work plan and timeline. As the project, by its very nature, is iterative, the work plan and timeline must remain flexible so that the RP team can respond as dynamics and requirements evolve. The work plan should include work streams for 1) collecting and analyzing institutional knowledge, 2) providing strategic thinking and guidance, 3) collecting and warehousing data and documents, and 4) aggregating information to be incorporated into the resolution plan.

Resolution planning is a complicated and lengthy exercise, but it can benefit a company beyond mere compliance with the filing requirement.

Consistent Message

Before the first series of information-gathering sessions begins, the RP team should establish a consistent message to be shared throughout the company regarding the process for resolution planning, the company's goals for the project, and the resolution options or strategies contemplated by the company.

Common Challenges

Common challenges for financial institutions include the following:

1. Efficiently managing the depth and breadth of the project, including locating, organizing, and incorporating the voluminous data required.
2. Establishing parameters for identifying material entities, core business lines, and critical operations and confirming the selection of each through internal dialogue and communications with the regulators.
3. Sampling and analyzing critical agreements (such as vendor and service-level agreements) and developing practical solutions for incorporation into the resolution plan.
4. Analyzing operations, business lines, and interconnections on a legal-entity basis.
5. Building plausible and informed assumptions to support the resolution plan.
6. Coordinating data collection and analyses as required under different resolution-planning requirements or non-U.S. insolvency regimes (applies only to companies operating in multiple countries).

The RP team should consider each of these challenges while developing the project work plan and establishing work streams.

Planning and Process

Above all else, a resolution planning process must be guided by practicality. Resolution planning is a complicated and lengthy exercise, but it can benefit a company beyond mere compliance with the filing requirement. To maximize value during the process, institutions should be mindful of the following lessons learned.

Allocate Sufficient Time and Resources

Resolution planning is a new and time-consuming process, so advance planning and an early start are recommended. During the planning phase, consultation and coordination with outside advisors, who can add value when included as part of the RP team, will lead to a more efficient and cost-effective process.

As the RP team is being formed, consider the strength of each component part—writing, analysis, data compilation, institutional knowledge, and so on—and capitalize on those strengths. Tasking an attorney to compile voluminous data, while assigning an analyst to draft a description of applicable insolvency proceedings, is a poor use of resources. The planning phase can be used to establish work-stream teams and designated leaders, as well as to create a skeleton around which the plan can be developed. Ideally, given the time demands, companies subject to the July 1, 2013 deadline should establish their teams, begin to develop their process, and select their advisors no later than October 2012 to allow for sufficient execution time.

Centralize Drafting

To ensure consistency and continuity, the RP team should assume primary drafting responsibility. Doing so will enable the team to use standard and defined terms, spot inconsistencies, and develop themes throughout the plan. With a project of this size, continuity is critical. What may seem a small change or nuance in the language of one section can impact many other sections of the resolution plan. Further, on a purely technical level, consistent use of terms and concepts from the outset will avoid countless hours wasted on standardizing the plan's language later on.

While centralized drafting is critical to maintaining the consistency and continuity of the process, input from the front office is essential to developing the factual underpinnings and analysis. Accordingly, there must also be a process for iterative and dynamic dialogue to lay the foundation of the plan.

Some institutions may choose to task the front office with developing a first draft of designated sections, to be revised and refined later by the RP team. The disadvantage of this approach is that the output from each business line will vary significantly in form and substance. If the RP team works with the front office to collect the information and develop the analysis, the RP team can generate a consistent work product.

Facilitate Iterative and Dynamic Dialogue

Both the resolution planning process and the related regulatory framework are in their formative years, so the process, by its very nature, is iterative and dynamic. The upside is that there is no right answer and no prescribed means to address any particular issue. In fact, for the first round of submissions, the regulators have suggested that no initial resolution plan will fail.

The downside is that assumptions, obstacles, variables, strategies, and everything else will change, perhaps materially, as the plan evolves and internal and external dialogue ensues. It is incumbent on the leadership of the RP team to manage the expectations of the board, the management, the front office, and the RP team members so that this evolution is understood and accepted and doesn't become a source of friction and confrontation.

The resolution plan will develop over time through internal dialogue (between the RP team and the front office) and external dialogue (between the RP team and the regulators or other companies). This dialogue will lead to modifications that could permeate the entire plan.

For example, during the first round of resolution plans, many institutions did not initially consider pure service companies to be "material entities." However, a few months before the submission deadline, the FDIC and the Fed provided further guidance that resulted in some of these service companies being treated as material entities. What might have seemed a minor change from the regulators' perspective required significant revisions to individual resolution plans.

Another example of the need for flexibility occurs when a new strategy is developed late in the process to address regulatory concerns or to facilitate greater consistency across core business lines and critical operations. The key to a successful process is to remain flexible and embrace the iterative and dynamic nature of the dialogue rather than fight it.

Develop Integrated Strategies

The RP team should hold a series of meetings with executives from the front office to learn from each other and to develop integrative strategies. While the RP team will educate the front office on the resolution planning process—objectives, assumptions, strategies under consideration, parameters, and applicable insolvency regimes—the various front-office lines will educate the RP team about their businesses and critical operations. Each session between the RP team and front-office personnel should be a dialogue that facilitates the sharing of ideas and strategic considerations, rather than a monologue involving static presentations or lectures.

Analogies and explanations often help in conveying complex concepts. For example, most resolution plans include at least one resolution option premised on a sale of assets. To stimulate discussion, ask the front office, "If a competitor failed, what would you want to acquire and what information would you need to make an informed decision about the acquisition?" Similarly, framing questions as open-ended rather than leading will elicit discussions rather than assertions with little supporting evidence. For example, it is better to ask, "How could we preserve value in the repo book if the broker-dealer is failing?" as opposed to, "There is no way to preserve value in the repo book if the broker-dealer is failing, right?"

Separate meetings are often held with the front office for each of the core business lines. However, financial institutions often have issues that are common to their material entities, core business lines, or critical operations. For example, issues related to shared intellectual property (IP) and personnel frequently affect multiple entities, business lines, and operations. Accordingly, the RP team must synthesize this information to develop integrated strategies, consistent assumptions, and continuity throughout the plan.

The key to a successful process is to remain flexible and embrace the iterative and dynamic nature of the dialogue rather than fight it.

For common issues, the RP team should develop a company-wide strategy and preview it with front-office teams to elicit feedback on the approach and to explain the chosen strategies. Doing so may help focus the businesspeople on the issues unique to their core business line or critical operation. This approach streamlines the process and avoids wasting time on issues that permeate the organization.

Capitalize on Existing Resources

It may be stating the obvious, but the RP team should capitalize on existing resources. Public filings can be used to gather basic information about the company and generate a rough outline of the resolution plan. Existing internal reports may be useful in compiling the required data. Systems already in place may serve to collect information or may be

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modified to do so. Similarly, when it comes to forming the core RP team, employees with broad exposure to business lines and operations can be valuable assets.

For institutions subject to multiple resolution planning regimes, the FDIC and the Fed have intimated that it is acceptable to prepare a single resolution plan (as opposed to one for each jurisdiction), as long as the unified resolution plan addresses all of the U.S. reporting requirements under the Dodd-Frank Act.

In summary, adhering to the five recommendations outlined above will enable financial institutions to manage this otherwise cumbersome process efficiently in terms of time, cost, and expectations.

Substantive Development of the Plan

While process and planning are important, so is substance. Below are some lessons learned with respect to the substantive development of a resolution plan.

Frame Fundamental Assumptions

Consistent with the concepts of continuity and consistency, the RP team must develop fundamental assumptions to be relied upon throughout the planning process. Many of these assumptions will be developed through iterative and dynamic dialogue with the front office, while others will be based on parameters provided by the regulators or identified in discussions with peers.

The assumptions will be disclosed in the first section of the plan's strategic analysis and will provide context for the entire plan, thus reducing the number of variables. In addition, assumptions may be used to address concerns outside of the company's control. For example, regulatory cooperation is frequently necessary for a successful resolution, but it is entirely outside of the company's control. As a result, it is common to assume regulatory cooperation.

While assumptions are often developed early in the process, it is important to reexamine them at critical junctures to test their validity and applicability to the plan as it evolves.

Identify and Address Operational and Financial Interconnections

An essential component of resolution planning is the need to identify, analyze, and (potentially) modify the ways in which the company's material entities, core business lines, and critical operations interconnect. Although each company's internal interconnections are unique, most fall into one of two categories: financial or operational.

Common forms of financial interconnectedness include centralized cash management and inter-entity collateral management, both of which rely on the institution's ability to move cash and collateral freely among its various legal entities. Operational interconnections, on the other hand, often include shared employees, shared technology, and shared locations.

In addition, the RP team should undertake a review of representative samples of its critical vendor and service-level agreements to assess whether any revisions are required and how these agreements may impact the resolution process.

In resolution, each legal entity is effectively isolated from the others and each may be subject to a different type of proceeding (for example, the holding company may be in Chapter 11 under the Bankruptcy Code, while the broker-dealer is in a proceeding governed by the Securities Investor Protection Act and the insured depository institution is in a proceeding governed by the Federal Deposit Insurance Act).

A further complication arises with respect to derivatives and other qualified financial contracts (QFCs). As a general rule, most counterparties to derivatives, repos, and other qualified financial contracts terminate their positions when the counterparty enters an insolvency proceeding. Although certain limited exceptions apply, such mass terminations are simply a natural consequence of the commencement of resolution proceedings for entities that are parties to QFCs.

Given these complexities, the RP team must not only identify the interconnections, but also develop institution-specific strategies to address each entity's need for liquidity, access to collateral and custodied assets, and shared employees, technology, and locations.

Catalog Intellectual Property

In addition to interconnections, a significant challenge for many institutions comes in cataloging their intellectual property, such as internally developed trading algorithms, and mapping each piece of IP to the legal-entity owner and licensees as well as the applicable core business lines and critical operations. This is particularly important because many companies have a significant amount of unregistered IP. This task should be started early and updated regularly.

Recognize Practical Limitations

In their resolution plans, institutions should identify issues spotted through their internal processes, including areas of potential systemic risk. But they should also remember that it is impossible to eliminate all systemic risk and unfeasible to have a solution for every problem that may arise. Instead, the RP team should explore practical mitigation options and make note of industry-wide challenges.

Meld Disclosure and Advocacy

A resolution plan is as much about advocacy as it is about disclosure of information. An institution can use its plan to advocate preferred internal solutions to potential systemic issues and to educate regulators about existing risk management and other strategies that contain or mitigate risk. In addition, it can use the plan to assert why certain allegedly "risky" business lines or practices actually pose limited systemic risk based on market share, internal controls, or industry standards.

A resolution plan can also identify obstacles outside of the company's control and the parties best suited to solve the problem, such as other market participants or the regulators. Lastly, a resolution plan also provides a forum for advocating preferred solutions to horizon issues and for educating regulators about operations to facilitate future discussions on M&A transactions and new product lines.

Reflect and Improve

Resolution planning has been or will be adopted by every G-20 member country and thus is here to stay. Financial institutions should embrace resolution planning as an opportunity to reflect on and improve their overall administrative operations and general business practices—capitalizing on the forced introspection to identify ways to reduce costs, enhance revenues, limit risk, and streamline processes.

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The resolution planning process requires both a big-picture analysis of the institution and a detailed analysis of each core business line and critical operation. As a result, it allows an institution to gain valuable insight by examining its inherent interconnectedness, the obstacles to resolution, and any exposure to or dependency on other SIFIs.

Conclusion

There is no denying that resolution planning is a time-consuming and costly process that can disrupt normal business operations. But with careful planning, forced introspection, and the strategic blend of advocacy and disclosure, resolution planning can be an efficient process that yields benefits far beyond satisfying the regulatory requirements. ❖

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