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Resolution Lemonade: Finding the Positives in Recovery and Resolution Planning

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Resolution plans, with all of their associated costs and burdens, are here to stay. The authors suggest that systemically important financial institutions should focus on the benefits of resolution planning beyond regulatory compliance.

Prudential supervisors around the world are adopting recovery and resolution planning ("RRP") for systemically important financial institutions ("SIFIs") as a means to mitigate systemic risk. While views may differ on the utility of the RRP process, it is nonetheless a process that is here to stay. Thus, SIFIs can either choose to comply begrudgingly or embrace the RRP process. This article is for those SIFIs seeking to turn the perceived negatives of the RRP process — the lemons — into positives — the lemonade. The RRP process is essentially a form of contingency planning. A recovery plan addresses how the SIFI could recover from financial distress and avoid failure, while a resolution plan addresses how the SIFI might resolve itself in the event of failure and, in so doing, mitigate any systemic risk to the U.S. financial markets. As many recent examples (such as Lehman Brothers, Bear Stearns and MF Global) demonstrate, financial distress or failure of a SIFI can occur quickly and have a material impact on financial markets. In contrast, the RRP process is designed to give SIFIs and their regulatory su-

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pervisors ample time to develop optimal resolution strategies and take steps to mitigate impediments or barriers to resolution — all without the pressure of an impending crisis. Not only is the RRP process a new risk management tool for SIFIs and regulators alike, it can also be utilized by SIFIs as a communication tool to educate and advocate.

REGULATORS

In the U.S., all SIFIs are required to submit their resolution plans to the Federal Deposit Insurance Corporation ("FDIC") and the Federal Reserve Board ("FRB") and some SIFIs are also asked to submit a recovery plan. The process, however, is an iterative one involving recurring dialog between the SIFI and the FDIC and FRB. Typically, a series of meetings are required by the regulators with additional meetings conducted on an as needed or voluntary basis. Regulators also have staff on site to facilitate interaction throughout the process.

The give and take among SIFIs and regulators during the resolution planning process provides a centralized forum for SIFIs to educate regulators about the uniqueness of their institution, including its governance process, business operations, and checks and balances for risk management. SIFIs can promote their strengths and provide the regulators with a detailed description of their business to shape the regulators' perception of their institution. Laying this groundwork will not only inform the regulators' views with respect to a SIFI's resolution plan, but it will also lay the foundation for future endeavors that a SIFI may wish to pursue. For example, if a SIFI wants to make a large acquisition or conduct a new business that requires regulatory approval, the regulators' understanding of the SIFI's business developed during the resolution process will advance the SIFI's interests and should expedite the regulators' review and consideration of the request for approval.

The ability to meet with and educate regulators on a regular basis is not just good for SIFIs and resolution planning, but it also improves market policies and rules. Resolution planning forces regulators to enter the trenches with SIFIs. As part of their resolution plan, SIFIs are required to identify "barriers" or impediments to their resolution. This includes not just internal barriers that a SIFI might face, but also industry barriers that will require regulatory involvement and policies to rectify. For example, in connection with the failure of Lehman Brothers, many third parties that provided critical services to Lehman and its clients, such as financial market infrastructures ("FMIs") (e.g., clearing houses that store critical client information and assets for SIFIs), discontinued their services upon Lehman's failure and denied Lehman access to critical information leading to market disruption. If FMIs do not cooperate in the resolution of a SIFI, that could prevent the SIFI from successfully resolving itself without systemic disruption. Through the resolution process, these types of very specific problems are identified and discussed with regulators. If regulators have a deeper understanding of market wide impediments, regulatory responses and new policies will be more direct and effective, which will inure to the benefit of the market as a whole.

THE PUBLIC

Resolution planning is primarily a risk management exercise. The goal is to ensure that in the event a SIFI incurs a significant stress event, it can be resolved without disruption to the financial system of the country or countries in which the SIFI operates. A resolution plan sets forth a SIFI's action plan in the event there is a financial emergency. The resolution plan will include, among other things, a discussion of the SIFI's existing risk management policies, its business operations, potential impediments to a successful resolution, and core assumptions that the SIFI has made in developing its resolution strategy. The SIFI's regulators will scrutinize the resolution plan to ensure that it is feasible and to confirm that the SIFI has strong risk management policies in place to reduce the risk of a financial collapse or, if necessary, to be resolved without disruption to the financial system.

In the U.S., a summary of each SIFI's resolution plan must be made publicly available. Although a more detailed private section is submitted to — and accessible only by — the regulators, the public section offers SIFIs a unique opportunity to send a clear and concise message about their business and risk management practices that can help shape the public perception of the institution. A resolution plan can also deepen the public's understanding of the SIFI's strengths. Although SIFIs may already be required to disclose some of this information in other public filings, such as a company prospectus, resolution planning is a more focused inquiry that is blessed by regulators. It requires SIFIs to address one direct question with considerably more detail and support than other public filings: is your institution resolvable without causing systemic disruption to the financial system? SIFIs should jump at the chance to declare: *YES we are!*

CUSTOMERS

One of the lessons learned from the collapse of MF Global was that the failure of major financial institutions to properly segregate and account for client assets can have a serious effect on not only the clients of that institution, but also a domino effect on other parties such as counterparties of those clients. Accordingly, a focus of the Dodd-Frank Act that must be addressed by SIFIs in their resolution plans is the protection of customer assets and the SIFI's strategy for the continuation or controlled winddown of its operations that are critical to the functioning of the financial markets, such as clearing and exchange traded securities.

Naturally, all customers will be interested in and extremely sensitive to a SIFI's policies and strategies with respect to customer assets and critical operations. SIFIs can use the resolution process to reassure customers of their strong risk management policies and advise them of their compliance with the requirements of the Dodd Frank Act. SIFIs should leverage the information collected and prepared during resolution planning, particularly any enhancements made to risk management practices, to promote their business and to respond to client inquiries. SIFIs can also use their resolution plans and compliance with the Dodd-Frank Act to attract new clients.

THE BOARD

Resolution planning gives the board of directors of a SIFI an opportunity to gain a deeper understanding of the institution's risk profile and to test its preparedness for potential financial distress. Although boards of directors are likely to already be familiar with their companies' risk profile and management policies, resolution planning is an opportunity for boards to review and reconsider such policies through an alternative lens (the lens of resolution planning and potential distress). In light of the fundamental goal of resolution planning to ensure that the institution is resolvable without systemic impact or government support and the regulatory oversight and approval involved in the process, boards are more likely to apply greater scrutiny to existing risk management policies. This deeper understanding and testing by boards of directors should enhance risk management by SIFIs. Resolution planning may also inform a board's views in future strategic decision making.

THE BOTTOM LINE

Last, and perhaps most important, resolution planning can improve the bottom line for SIFIs. Identified below are some of the primary ways that resolution planning can help SIFIs identify and implement improvements in their risk management and business operations, all of which can improve the institution's success and profitability.

Risk Management

As noted, resolution planning is primarily a risk management exercise. In developing a resolution plan, SIFIs are forced to identify risks to their business and existing risk reducing measures. The identified risks will include not only the risks that a SIFI may pose to the financial system at large, but also risks within the SIFI that, if they materialized, could cause the SIFI to suffer financial loss or a failure. Resolution planning forces SIFIs to test their risk assumptions and controls under a variety of economic scenarios with regulatory oversight and input. If there are deficiencies in a SIFI's risk management practices, such as, for example, an assumption underlying a SIFI's risk management strategy that no longer holds true, the resolution planning process will bring this shortcoming to light so it can be corrected. As such, resolution plans will result in SIFIs that are more risk averse and, therefore, more attractive to clients and counterparties.

Improvements in Business Operations and Efficiencies

In addition to a SIFI's risk management practices, the resolution plan will include descriptions of the SIFI's business operations and identify potential impediments to resolution. For example, a core business operation may be situated in a legal entity subject to a SIPA receivership, while a critical function for that business operation may be housed in a separate legal entity that would be subject to an FDIA receivership. While the FDIC and the SIPA trustee might cooperate early in the process to mitigate systemic impact, ultimately, there will be complete separation. When afforded the opportunity for advance planning, which is the cornerstone of the resolution planning process, the SIFI might choose to move the critical function to the legal entity whose business operations it supports. As a result, inefficiencies can be exposed, synergies identified and improvements implemented as a result of the resolution planning process.

Firm Integration

Resolution planning cannot be done in a vacuum. Preparing a resolution plan requires a firm-wide effort in order to produce an integrated, comprehensive and consistent product. SIFIs cannot present resolution strategies that are feasible from a risk-management perspective but do not hold true from a business perspective. As such, while most SIFIs will typically assemble a team of project managers to lead the preparation of the resolution plan, a successful resolution plan will require significant contributions and input from many departments and employees across the firm.

Given the collective approach that must be taken with resolution planning, a wide range of employees beyond just upper management and front office personnel will acquire a deeper understanding of the institution's firm-wide business, restrictions and interconnectedness. Each of the departments of the SIFI will develop a greater appreciation for the functions, policies and objectives of the other departments in the institution. This enhanced understanding will not only improve the quality of the resolution plan, but it will also help SIFIs become more integrated in their operations. A more widely integrated institution that truly understands its strengths and challenges will improve the bottom line.

Streamlined Process for Integration or Separation

The RRP process requires SIFIs to identify material entities, critical operations and core business lines and to educate regulators about each of the foregoing through the resolution plan. Resolution plans include extremely detailed information regarding a SIFI's businesses, its day-to-day operations, critical infrastructure required to operate each business line and strategies to resolve such entities and businesses in the event of financial distress, such as a going concern sale or controlled winddown. The information gathered and strategies prepared are specific to each material entity, core business line or critical operation and SIFIs are required to consider how each one of these could be individually resolved in the event of financial stress to the institution.

Given the level of specificity and detail required, resolution plans will serve as a useful tool for SIFIs to integrate new businesses into existing operations or to separate certain businesses or operations even outside of a resolution scenario. The resolution plan can inform the views of a SIFI and its management in connection with a major purchase or sale of a material entity or business. Much of the diligence and preparation that is required for such transactions will have already been completed through the resolution process. Resolution plans can also be used to integrate new businesses into a SIFI's operations and can be provided to a third-party purchaser to enable the purchaser to integrate a business line or operation into its business.

Legal Entity Rationalization

Many institutions have recently focused on the cost cutting benefits of legal entity rationalization. Over the years, there has been a proliferation of legal entities at SIFIs driven by, among other things, acquisitions, tax planning and globalization. However, many of the entities no longer serve a purpose and others may be redundant. Maintaining unnecessary legal entities results in increased costs and complexities in the operations of SIFIs, such as compliance burdens, taxes and reporting complications. Accordingly, SIFIs have been considering legal entity rationalization approaches as a means to develop a plan to reduce the number of legal entities within their institution, eliminate redundancies and align business operations with entities.

Legal entity rationalization requires input from multiple functions of a SIFI including finance, legal, risk management, human resources and operations, to identify opportunities to reduce the number of legal entities required to operate a SIFI's business and to ensure that eliminating or combining legal entities is feasible from all perspectives of the institution. Through the RRP process, SIFIs will have already performed much of the work required to implement a legal entity rationalization strategy. In preparing a resolution plan, SIFIs must not only identify and consider their material entities, but also any entities that support the business of material entities. As a result, the RRP process requires SIFIs to review all of their entities and businesses to determine what functions each of them performs and how they are integrated within the firm. In preparing their resolution plans, SIFIs will identify opportunities to reduce the number of legal entities and to understand what risks and costs are posed by maintaining such entities. This investigation will benefit SIFIs beyond the resolution process into their daily operations.

Industry and Business Developments

In the U.S. and other countries, SIFIs are required to refresh their resolution plans on an annual basis. In refreshing their resolution plans, SIFIs will need to address changes to laws, policies and market practices that will affect their resolution plans and business operations. For example, in refreshing their resolution plans next year, the first wave of SIFI filers in the U.S. will need to take into account the requirements of the Dodd-Frank Act for central clearing of certain derivatives transactions and the treatment of related collateral. SIFIs and their employees who are responsible for preparing resolution plans will need to stay alert to and understand industry changes. This knowledge and experience will benefit SIFIs beyond the resolution process and trickle into its day-to-day operations. A wider pool of employees that is familiar with and appreciates industry and legal developments on a real time basis should improve the SIFIs functioning and success.

CONCLUSION

Resolution plans, with all of their associated costs and burdens, are here to stay. SIFIs should accept this reality and focus on the benefits of resolution planning beyond regulatory compliance. This approach is far better than sour lemons.