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Living Wills: A User's Guide To Dodd-Frank's Bequest to Banks

June 13, 2011

In 2010, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act. While many of its provisions have received greater publicity — such as the Orderly Liquidation Authority of Title II and the swap provisions of Title VII — the so-called “living will” provisions of Dodd-Frank are now receiving more focused attention. Section 165(d) of Dodd-Frank requires “systemically significant” financial institutions to periodically report to the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Company and the Financial Stability Oversight Counsel a plan for the rapid and orderly resolution of their business in the event of material financial distress.

The FDIC and the Federal Reserve recently proposed joint rules governing the implementation of this “living will” requirement. The proposed rules would require systemically significant financial institutions to file and update their resolution plans periodically and file related quarterly credit exposure reports. As discussed below, the proposed rules provide extensive detail concerning the content of these filings. The comment period for the proposed rules ends on June 10, 2011, with the final rule expected no later than January 2012.

The proposed rules are intended to (a) reduce the possibility of the failure of organizations that were previously considered “too big to fail,” and (b) minimize the impact of the failure of such an organization on the broader economy. In proposing the rules, FDIC Chairman Sheila C. Bair stated:

The ability to plan in advance for the orderly resolution of a systemic entity is key to ending Too Big To Fail. Viable resolution plans will require systemic institutions to conduct a strategic analysis on how they could be resolved under the Bankruptcy Code as well as evaluate significant credit exposures and other key information across the entities and their affiliates. These plans will be instructive to institutions as a way for them to better understand how their business lines interact and how to mitigate the effects of failure risk. The plans also will help inform the FDIC on how to lessen the systemic ripple effects in the event one of these companies must be resolved under the new Orderly Liquidation Authority.

The living will requirement imposes significant informational and oversight burdens on large financial institutions. We expect these institutions to devote enormous resources to the process of preparing living wills over the next year and to update quarterly and annually. Given the burden imposed by the proposed rules, systemically significant institutions that have not already done so may find it prudent to begin the process of preparing their living will without delay.

It remains unclear how the living wills will be of use. Although the living wills may help institutions prevent another situation similar to the systemic failure of 2008, the significant undertaking required by the proposed rules may prove for naught when crisis actually arises. Predicting the cause of a future massive disruption is, of course, difficult. Thus, any preparation may not address the ultimate issues that arise.

The proposed rules leave some other important questions unanswered. For example, the proposed rules require the financial institutions to draft their plan under the Bankruptcy Code, as opposed to the Orderly Liquidation Authority under Title II of Dodd-Frank.¹ It is unclear how the living will requirement and Orderly Liquidation Authority interact.

Who Must Comply With the Rules?

The proposed rules apply to "Covered Companies," defined to include:

- any non-bank financial company supervised by the Federal Reserve;
- any bank holding company that had \$50 billion or more in total consolidated assets; and
- any foreign bank or company that is a bank holding company or is treated as a bank holding company under the International Banking Act of 1978 and that had \$50 billion or more in total consolidated assets.

The proposed rules require that the resolution plan of a domestic Covered Company include information with respect to the subsidiaries and operations that are domiciled in the U.S. as well as foreign subsidiaries, offices, and operations. For a foreign Covered Company, the resolution plan must include information with respect to its domestic subsidiaries, branches, agencies, critical operations and core businesses.

The FDIC estimates that the rules will apply to approximately 124 organizations.

¹ The Orderly Liquidation Authority is a new federal receivership process created under Title II of Dodd-Frank. Under the Orderly Liquidation Authority, the FDIC may seize control of a financial company whose imminent collapse is determined by the Secretary of the Treasury to threaten the stability of the U.S. financial system.

What Do Covered Companies Have to Do?

The proposed rules impose ongoing obligations on a Covered Company to prepare and update its living will. Note that the board of directors of a Covered Company is required to approve each resolution plan prior to filing. In particular:

- Each Covered Company must file its initial resolution plan with the FDIC and the Federal Reserve within 180 days of the effective date of the final rule.
- Each Covered Company then must submit an annual updated resolution plan no later than 90 days after the end of each calendar year.
- Each Covered Company must file an updated resolution plan no later than 45 days after any event, occurrence, or change in conditions or circumstances which results in, or could reasonably be foreseen to have, a material effect on its currently filed resolution plan. Material events include, among other things, a significant acquisition or sale by the Covered Company or the loss of a material servicing subsidiary or servicing contract.

The initial submissions likely will not end the process. Following submission of a resolution plan, the FDIC and the Federal Reserve have 60 days to determine and acknowledge whether the resolution plan satisfies the minimum informational requirements of the proposed rules. If the FDIC and the Federal Reserve determine that the resolution plan is informationally incomplete, they will inform the Covered Company in writing of what additional information is required. The Covered Company would then be required to submit a modified resolution plan satisfying these requests.

After acceptance of the submission by the FDIC and the Federal Reserve, the agencies will review the resolution plan for compliance with the proposed rules. If, following this review, the FDIC and the Federal Reserve determine jointly that the resolution plan would not facilitate an orderly resolution of the Covered Company, then the FDIC and the Federal Reserve will notify the Covered Company of the plan's failure. Within 90 days of receiving notice of the insufficiency of its plan, a Covered Company must submit a revised resolution plan that addresses these deficiencies. The revised resolution plan would be required to address: (1) the revisions made by the Covered Company to address the deficiencies identified by the FDIC and the Federal Reserve; (2) any changes to the Covered Company's business operations and corporate structure that the Covered Company proposes to facilitate implementation of the revised resolution plan; and (3) why the Covered Company believes the revised resolution plan is credible and would result in an orderly resolution of the Covered Company under the Bankruptcy Code.

What Are the Key Aspects of the Resolution Plan?

In general, each resolution plan must include: (1) an executive summary; (2) strategic analysis of the plan for resolution; (3) a description of the corporate governance structure for resolution planning; (4) a summary of overall organization structure; (5) detail on management information systems; (6) a review of interconnections and interdependencies; and (7) supervisory and regulatory information.

The resolution plan of a domestic Covered Company shall include the information below with respect to its subsidiaries and operations that are domiciled in the United States as well as any foreign subsidiaries, offices, and operations. The resolution plan of a foreign Covered Company must include the information described below (other than the provisions regarding interconnections and interdependencies) only with respect to its U.S.-based subsidiaries, branches and agencies, and critical operations and core business lines. These entities must also include a detailed explanation of how resolution planning for its subsidiaries, branches and agencies, and critical operations and core business lines is integrated into the foreign-based Covered Company's overall resolution and other contingency planning process.

INITIAL LIVING WILL CHECKLIST:

I. Executive Summary. The proposed rules require a summary of:

- Key elements of the strategic plan for rapid and orderly resolution in the event of failure of the Covered Company.
- Material changes from most recently filed plans, including actions taken to improve the effectiveness of the resolution plan.

II. Strategic Analysis of the Resolution Plan's Components. This section provides the meat of the company's plan for orderly resolution. Each Covered Company must:

- Describe its plan for a rapid and orderly resolution, including:
 - Setting forth key assumptions and supporting analysis underlying the plan, including any assumptions made concerning the economic or financial conditions that would be present at the time the Covered Company sought to implement the plan.

- Detailing how reorganization or liquidation of the Covered Company could be accomplished in a manner that mitigates substantially the risk that the failure of the Covered Company would have a serious adverse effect on financial stability in the United States.
 - Identifying specific actions to be taken by the Covered Company to facilitate resolution.
 - Describing funding, liquidity, support functions, and other resources, including capital resources, and “mapping” them to the Covered Company’s material entities, core business lines and critical operations.
 - Detailing its strategy for maintaining and funding critical operations and core business lines during financial distress. This should also be “mapped” to the critical operations and core business lines.
 - Demonstrating how resources would be utilized to facilitate an orderly resolution.
 - Detailing its strategy in the event of a failure or discontinuation of a material entity, core business line, or critical operation, and the actions that will be taken by the Covered Company to mitigate adverse effects a failure will have on the financial stability of the company and the United States.
 - Detailing its strategy for ensuring that any insured depository institution subsidiary will be protected adequately from risks arising from the activities of any non-bank subsidiaries of the Covered Company.
- Identify the time period needed to implement the plan.
 - Describe any potential material weaknesses to execution of the Covered Company’s plan and detail actions and steps necessary to mitigate those weaknesses.
 - Provide a detailed description of the processes the Covered Company employs for:
 - Determining the current market values and marketability of the core assets.
 - Assessing the feasibility of the Covered Company’s plans.
 - Assessing the impact of any dispositions and restructurings on the value and operations of the Covered Company.
 - Demonstrate how core assets and critical operations could be resolved and transferred to potential acquirers.
 - Demonstrate how critical elements of the business operations could survive during material financial distress or the failure of key entities within the Covered Company.

- III. Description of Corporate Governance Structure for Resolution Planning.** This section details how the company prepared its resolution plan and requires the Covered Company to:
- Describe how resolution planning is integrated into the corporate governance structure.
 - Describe the Covered Company's procedures and internal controls governing preparation and approval of the resolution plan.
 - Identify the senior management official primarily responsible for overseeing the development and implementation of the plan.
 - Describe the nature, extent, and frequency of reporting to senior executive officers and the board of directors on development of the plan.
 - Describe the Covered Company's processes to collect and report the data underlying the plan.
 - Describe the nature of any planning to assess the viability of or to improve the resolution plan.
 - Identify and describe the relevant risk measures used by the Covered Company to report credit risk exposures both internally and to the appropriate Federal regulator.
- IV. Information Regarding Overall Organizational Structure and Related Information.** This section includes details on the company's organizational structure, finances, liabilities and assets and requires the Covered Company to:
- Provide a detailed description of the Covered Company's organizational structure, including:
 - An organizational chart of all material legal entities.
 - A "mapping" of the Covered Company's critical operations and core business lines.
 - Provide an unconsolidated balance sheet for the Covered Company and a consolidating schedule for all entities that are subject to consolidation.
 - Include a description of the material components of its assets, liabilities, critical operations, and core business lines.
 - Identify and describe the processes used by the Covered Company to determine to whom the Covered Company has pledged collateral, and identify the person or entity that holds such collateral, the jurisdiction in which the collateral is located and in which the security interest in the collateral is enforceable.

- Describe any material off-balance sheet exposures (including guarantees and contractual obligations).
- Describe booking of trading and derivative activities.
- Identify material hedges and hedging strategies of the Covered Company.
- Describe the process undertaken by the Covered Company to establish exposure limits.
- Identify major counterparties of the Covered Company and describe the interconnections, interdependencies, and relationships with those major counterparties.
- Analyze whether the failure of each major counterparty would likely have an adverse impact on the Covered Company.
- Identify each system on which the Covered Company conducts a material number or value amount of trades.
- Identify each payment, clearing, or settlement system of which the Covered Company, directly or indirectly, is a member and on which the Covered Company conducts material transactions and “map” membership in each system to the Covered Company’s material entities, critical operations and core business lines.
- If it has foreign operations, identify the extent of the risks related to its foreign operations and its strategy for addressing these risks.
- Evaluate the continued ability to maintain core business lines and critical operations in foreign jurisdictions during material financial distress and identify practical steps to address weaknesses or vulnerabilities.

V. Information Regarding Management Information Systems. This section includes details on the Covered Company’s relevant information management systems. Critical Companies must:

- Provide detailed inventory and description of key management information systems and applications supporting its core business lines and critical operations, including systems and applications for risk management, accounting, and financial and regulatory reporting.
- Identify the legal owner of all key management information systems.
- Identify the scope, content and frequency of the key internal reports used to monitor the financial health, risks, and operation of the Covered Company.
- Describe the process for the appropriate supervisory or regulatory agencies to access the management information systems and applications.

VI. Description of Interconnections and Interdependencies. This section sets forth the Covered Company's critical relationships. The Critical Company must:

- Identify interconnections and interdependencies within the Covered Company that, if disrupted, would materially affect the funding or operations of the Covered Company. Interconnections and interdependencies may include:
 - Common or shared personnel, facilities, or systems;
 - Capital, funding, or liquidity arrangements;
 - Existing or contingent credit exposures;
 - Cross-guarantee arrangements, cross-collateral arrangements, cross-default provisions, and cross-affiliate netting agreements;
 - Risk transfers; and
 - Service level agreements.
- Identify steps to ensure that service level agreements for key services survive insolvency.

VII. Supervisory and Regulatory Information. The Covered Company must detail:

- Its supervisory authorities and regulators and contact information for those authorities and regulators.

VIII. Miscellaneous. Additionally, the Covered Company must:

- Identify a senior management official responsible for serving as a point of contact.
- Include contact information for the material entities, critical operations, and core business lines of the Covered Company.
- Describe processes and systems to collect, maintain, and report data underlying the plan and identify any deficiencies in these processes and systems.
- Discuss plans to remedy the deficiencies.
- Demonstrate ability to produce promptly the data underlying the key aspects of the resolution plan.

What Must Each Updated Resolution Plan Include?

The Executive Summary of each updated resolution plan (updated annually or as a result of a material event) must contain the following:

- A description of all material changes from the Covered Company's most recently filed resolution plan.
- A description of any action taken by the Covered Company to improve the resolution plan's effectiveness or mitigate any material weaknesses or impediments to effective and timely execution of the resolution plan.

Any update may incorporate by reference informational elements from the previously submitted resolution plan, provided that:

- The resolution plan clearly indicates (1) the informational elements being incorporated by reference; and (2) which of the Covered Company's previously-submitted resolution plans originally contained the information being incorporated by reference.
- The Covered Company certifies that the information it is incorporating by reference remains accurate.

Any update filed as a result of a material event should (1) describe the material effects that the material event may have on the Covered Company's resolution plan; and (2) detail any actions that the Covered Company has taken or will take to address such material effects.

What Are the Key Aspects of the Credit Exposure Reports?

Each Covered Company is also required to submit a Credit Exposure Report to the Federal Reserve and the FDIC no later than 30 days after the end of each calendar quarter. The credit exposure reports should contain the following information:

- The aggregate credit exposure associated with (a) all extensions of credit, including loans, leases, and funded lines of credit by, (b) all committed but undrawn lines of credit by, and (c) all deposits and money placements by:
 - The Covered Company and its subsidiaries to each other significant company² and its subsidiaries; and

² The term "significant company" is defined to include all other Covered Companies and any other non-bank financial company that had \$50 billion or more in total consolidated assets as of the end of its most recently completed fiscal year.

- Each other significant company and its subsidiaries to the Covered Company and its subsidiaries.
- The aggregate credit exposure associated with all repurchase agreements, reverse repurchase agreements, securities borrowing transactions and securities lending transactions (each on both a gross and net basis) between the Covered Company and its subsidiaries and each significant company and its subsidiaries.
- The aggregate credit exposure associated with all guarantees, acceptances, or letters of credit (including endorsement or standby letters of credit) issued by:
 - The Covered Company and its subsidiaries on behalf of each significant company and its subsidiaries; and
 - Issued by each significant company and its subsidiaries on behalf of the Covered Company and its subsidiaries.
- The aggregate credit exposure associated with all purchases of or investments in securities issued by each significant company or its subsidiaries by the Covered Company and its subsidiaries.
- The aggregate credit exposure associated with all counterparty credit exposure in connection with a derivative transaction between the Covered Company and its subsidiaries and each significant company and its subsidiaries.
- A description of the systems and processes that the Covered Company used to:
 - Collect and aggregate the data underlying the Credit Exposure Report; and
 - Produce and file the Credit Exposure Report.
- The credit exposure associated with intra-day credit extended by the Covered Company to each significant company and its subsidiaries during the prior quarter.
- Any other transaction that results in credit exposure between a Covered Company and its subsidiaries and each significant company and its subsidiaries that the Federal Reserve, by order or regulation, determines to be appropriate.

Critical Considerations for Covered Companies

The proposed rules require large financial institutions to take several important steps. Most notably, the proposed rules require Covered Companies to undertake significant and burdensome reviews to prepare the initial and updated reports. We expect the plans to require costly efforts both internally and by external lawyers and financial advisors. Given the size and scope of the likely

obligations, Covered Companies should not delay in beginning preparation of the information and materials necessary for the living will.

Other issues for consideration:

- *Triggers.* The living will is designed to permit orderly liquidation at a time of great financial distress. However, as even the proposed rules acknowledge, by definition, it is difficult to anticipate the scenario that will give rise to an extreme financial crisis. Thus, preparing for relevant contingencies may prove difficult.
- *Internal Controls.* The proposed rules would require the Covered Companies to create internal systems for developing the living wills and updating them. Boards and management will need to anticipate and plan for this at the beginning of the process.
- *Confidentiality.* Both the resolution plans and the credit exposure reports require each Covered Company to disclose a significant amount of information to the Federal Reserve and the FDIC. As a result, there is the potential for public exposure of confidential data. The proposed rules permit a Covered Company to request confidential treatment of the information pursuant to existing Freedom of Information Act rules and the applicable agency rules, but it is not clear how, or if, this will be implemented.
- *Limited to the Bankruptcy Code.* The proposed rules contemplate that each resolution plan address the rapid and orderly resolution of the Covered Company pursuant to the Bankruptcy Code. It is unclear how the resolution plans are intended to interact with the receivership process of the Orderly Liquidation Authority under Title II of Dodd-Frank, which is a different regime than the Bankruptcy Code.
- *Consistency.* Firms should consider whether the disclosures in their living wills are consistent with disclosures in securities offerings and other public documents.

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Please feel free to contact any of the following Cadwalader attorneys if you have any questions about this memorandum.

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