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UK and U.S. Comparison of Living Wills Requirements for Banks in the UK and U.S.

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On 3 October 2011, the Financial Stability Board (FSB)[1] issued a press release announcing that it had approved "the package of policy measures to be submitted to the G-20's November summit to address the 'too big to fail' problems" posed by systemically important financial institutions (SIFIs).[2] The FSB package of policy measures includes:

- Key attributes of effective resolution regimes for financial institutions, which will form a new international standard for the features all national regimes should have to enable failing financial institutions to be resolved safely and without exposing the taxpayer to the risk of loss.
- A requirement that individual SIFIs that are determined to be globally important (G-SIFIs) have recovery and resolution plans, informed by resolvability assessments, and that home and host authorities develop institution-specific co-operation agreements and cross-border crisis management groups.
- Additional loss absorbency requirements for those banks determined to be G-SIFIs, based on the methodology developed by the Basel Committee on Banking Supervision for assessing the global systemic importance of banks.
- Measures to enhance the intensity and effectiveness of supervision, in particular of SIFIs, including improved data systems for risk management at SIFIs and assessments of the adequacy of supervisory resources.
- The enhancement of international standards for the robustness of core financial market infrastructures.

This package provides further guidance on the recommendations in the consultation document (Consultative Document) issued by the FSB on 19 July 2011.[3] The aim of the Consultative Document was to propose policy measures to improve the capacity of authorities to resolve SIFIs without systemic disruption and without exposing the taxpayer to the risk of loss. Long before the issuance of the Consultative Document and the 3 October 2011 FSB policy measures, the UK had already moved to require recovery and resolution plans[4] to resolve UK SIFIs and the U.S. had already moved to require resolution plans to resolve U.S. SIFIs.

In the UK and in the U.S., these plans are often referred to as "Living Wills." This first part of a two-part article takes a look at how Living Wills are being addressed in both the U.S. and the UK, which bank holding companies, foreign banking organizations and U.S. branches and agencies of international banks are covered, and the due dates set forth by each country's regulators.

Living Wills in the UK

The Banking Act 2009 created a Special Resolution Regime (SRR) giving the Financial Services Authority (FSA), the Bank of England and HM Treasury various tools for resolving failed deposit-taking financial institutions. However, the UK authorities require detailed knowledge and understanding of a financial institution's business to exercise the SRR tools and enable the orderly resolution of a failed financial institution without relying on taxpayer support. Using powers given to it under the Financial Services Act 2010, the FSA is currently consulting firms and interested parties on proposals for certain financial services firms to prepare and maintain Recovery and Resolution Plans (RRPs) and, in addition, for firms holding client money and assets to develop CASS Resolution Packs (CASS RPs)[5] to promote the swift return of clients' money and custody assets (CMA) should they fail. Some firms will have to prepare RRPs and CASS RPs; smaller firms with CMA will only have to prepare CASS RPs.

– Due Dates for Living Wills in the UK

The FSA will publish final rules in the first quarter of 2012. Certain rules will come into effect during the first quarter of 2012, but the FSA will also provide transitional rules so firms will have until June 2012 to prepare their first RRPs.

Living Wills in the U.S.

On 21 July 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank). Commonly referred to as "Section 165(d)" of Dodd-Frank, 12 U.S.C. 5365(d) requires U.S. SIFIs to file Living Wills. To implement the requirements of Section 165(d), on 13 September 2011, the Federal Deposit Insurance Corporation (FDIC) issued a final rule[6] (FDIC Final Rule). In response to comments, the proposed rule regarding Living Wills required by Section 165(d) was substantially changed by the FDIC Final Rule. The Federal Reserve approved the FDIC Final Rule on 17 October 2011.[7]

In addition, on 13 September 2011, the FDIC approved an interim final rule[8] (Interim Final Rule), which requires covered insured depository institutions with $50 billion in total assets (CIDIs) to submit to the FDIC periodic contingency plans for their resolution in the event of a failure. The Interim Final Rule, which is effective from 1 January 2012, is designed to complement the FDIC Final Rule. The FDIC Final Rule requires a Living Will to help resolve U.S. bank holding companies under Title 11[9] of the U.S. Code. The Interim Final Rule requires a Living Will to help the FDIC resolve a CIDI under the FDIA.[10] The time frames for filing CIDI Living Wills with the FDIC are the same[11] as the time frames for filing SIFI Living Wills, and the intent of the FDIC is to have the filing of the CIDI resolution plan correspond to the filing of the SIFI resolution plan. Moreover, the CIDI resolution plan may incorporate data and other information directly from the SIFI resolution plan. The Interim Final Rule seeks comment on 17 wide-ranging questions raised by the FDIC on the scope, definitions, strategic analysis, governance, informational elements, and process of the Interim Final Rule. This means that the Interim Final Rule may change after the close of the comment period on 21 November 2011.

– Due Dates for Living Wills in the U.S.

Rather than require all U.S. SIFIs to submit Living Wills at the same time, as was originally proposed by the FDIC and the Federal Reserve, the FDIC Final Rule requires a staggered process primarily based upon the amount of non-bank assets held by the U.S. SIFI. As a result, U.S. SIFIs will now be placed in one of three groups, commencing with those SIFIs having the most non-bank assets. The rationale for the three groups is to allow the regulatory agencies to focus first on the largest and most complex U.S. SIFIs and to gain experience that may be used in assessing the Living Wills of the other two groups. The Federal Reserve and the FDIC have indicated publicly that Group I Living Wills will allow them to gain knowledge that they will use to evaluate Group II and Group III Living Wills. It is likely that the FDIC and the Federal Reserve consulted with the UK supervisory agencies, because the Living Wills filing dates for UK SIFIs and U.S. SIFIs are very close in time.[12]

Group I,[13] whose Living Wills are due on 1 July 2012, includes U.S. bank holding companies (and foreign banking organizations (FBOs), but limited to their U.S. non-bank assets) with at least $50 billion in consolidated assets which also have $250 billion or more in non-bank assets, and any organization designated as a SIFI by the Financial Stability Oversight Council (FSOC). Some of the financial institutions in Group I include Bank of America Corporation, JPMorgan Chase & Co., Citigroup Inc., The Goldman Sachs Group, Inc. and Morgan Stanley. Group II,[14] whose Living Wills are due on or before 1 July 2013, includes U.S. bank holding companies (and FBOs, limited to U.S. non-bank assets) with at least $50 billion in consolidated assets which are not included in Group I and which also have $100 billion or more in non-bank assets, and any organization designated as a SIFI by the FSOC. Group III,[15] whose Living Wills are due on or before 31 December 2013, includes all U.S. SIFIs not in Group I or Group II with less than $100 billion in non-bank assets. Most U.S. SIFIs that are U.S. branches and agencies of international banks are likely to be in Group III, because the initial focus of the Federal Reserve and the FDIC is on U.S. non-bank assets rather than either U.S. bank assets or global non-bank assets. A U.S. SIFI with less than $100 billion in non-bank assets and total insured depository institution assets that comprise at least 85 percent of the U.S. SIFI's total consolidated assets may file a tailored plan[16] that focuses on non-bank operations. A company that becomes a SIFI after the effective date of the FDIC Final Rule must submit its Living Will by the next 1 July following the date on which the company becomes a SIFI, if that date is at least 270 days after the date on which the company becomes a SIFI.[17]

The FSOC has not yet designated any SIFI. However, on 11 October 2011, the FSOC issued a second notice of proposed rulemaking and interpretive guidance with a request for public comment[18] (FSOC Proposed Rule). The FSOC Proposed Rule clarifies the process the FSOC will use to designate non-bank financial companies[19] as SIFIs. Under Section 113[20] of Dodd-Frank, the FSOC designation means these SIFIs will be subject to prudential standards (e.g., enhanced supervision and regulatory standards) and supervision by the Federal Reserve. Due to the size of these SIFIs, the Federal Reserve is likely to have a core staff of examiners located on-site at the SIFI's main office, and those examiners will effectively conduct inspections and examinations of areas of the SIFI on each business day. It is possible that the FDIC will also have onsite examiners at the location. Federal Reserve examiners will require substantial recordkeeping, report filing, policy development, staffing, and systems upgrades. The Federal Reserve is also likely to require enhanced internal controls, expanded compliance structures, more focused risk management, and a wider scope of audits. Since the examiners will be onsite, these SIFIs will likely receive a consistent dose of corrective action letters and examinations that are much tougher than any audit undertaken at the SIFI prior to the SIFI designation.

All of this means that the cost of the SIFI designation (i.e., the enhanced supervision, the increased capital and liquidity requirements, and other requirements of the Federal Reserve and the FDIC) will be in the millions of dollars. For some companies, particularly those companies without central operations and integrated systems, the cultural and budgetary shock to the company will be extreme. Examiners are likely to criticize these companies for having "silos" that produce risk management gaps. The solutions to these gaps are usually increased staff, upgraded systems, stronger internal controls, changes to corporate governance, and enterprise-wide policies and procedures. These companies are likely to be asked to dramatically increase their expenses at the same time that demand for their products is weak.

In determining whether to designate a company as a SIFI, Dodd-Frank and 12 C.F.R. 1310.11(a)[21] require the FSOC to take into account the following 11 factors:

- Extent of the leverage of the company and its subsidiaries;
- Extent and nature of the off-balance-sheet exposures of the company and its subsidiaries;
- Extent and nature of the transactions and relationships of the company and its subsidiaries with other significant non-bank financial companies and significant bank holding companies;
- Importance of the company and its subsidiaries as a source of credit for households, businesses, and state and local governments and as a source of liquidity for the U.S. financial system;
- Importance of the company and its subsidiaries as a source of credit for low-income, minority, or underserved communities, and the impact that the failure of such company would have on the availability of credit in such communities;
- Extent to which assets are managed rather than owned by the company and its subsidiaries, and the extent to which ownership of assets under management is diffuse;
- Nature, scope, size, scale, concentration, interconnectedness, and mix of the activities of the company and its subsidiaries;
- Degree to which the company and its subsidiaries are already regulated by one or more primary financial regulatory agencies;
- Amount and nature of the financial assets of the company and its subsidiaries;
- Amount and types of the liabilities of the company and its subsidiaries, including the degree of reliance on short-term funding; and
- Any other risk-related factors that the FSOC deems appropriate either by regulation or on a case-by-case basis.

These statutory requirements proved to be unhelpful in predicting which companies might be designated by the FSOC. On 6 October 2010, the FSOC issued an advance notice of proposed rulemaking and on 26 January 2011, the FSOC issued a notice of proposed rulemaking, each of which was designed to provide guidance on how the SIFI determinations would be made. The notices were criticized as simply a restatement of the statutory requirements. The FSOC Proposed Rule is designed to address that criticism. Indeed, during testimony before the U.S. Congress on 6 October 2011, U.S. Secretary of the Treasury Timothy Geithner indicated that, after the 11 October 2011 meeting of the FSOC, the FSOC would issue further clarifying guidance that would help non-bank financial institutions better understand the factors that the FSOC will employ in determining whether a particular non-bank financial institution will be designated a SIFI. Secretary Geithner was referring to the FSOC Proposed Rule.

In the Appendix to the FSOC Proposed Rule, the FSOC further explained that it will use a three-stage process to make a determination on its designations. The first stage is a strictly quantitative test designed to identify the companies most likely to satisfy one or more of the determination standards. The second stage is designed to analyze and prioritize those companies identified in the first stage. Following the second stage, the companies that are selected for further review will be notified that they are being considered for designation. It is likely that public companies will disclose this information in their financial reporting to the SEC in the same way that they disclose governmental investigations.

The third stage is designed to have the companies go through an in-depth evaluation of information provided by the company and information compiled by the FSOC. Though the FSOC may make a designation at any stage, it is likely that determinations will be made after the third stage. If a company is designated, then it may request a hearing to challenge the designation. If the FSOC is unable to make a determination, the FSOC may request the Federal Reserve to conduct an examination of the company and its subsidiaries for the sole purpose of determining whether the company should be supervised by the Federal Reserve. Similarly, the FSOC may, on its own initiative or at the request of the Federal Reserve, require the financial activities of a company to be supervised by the Federal Reserve and subject to prudential standards if the FSOC determines that a material financial distress related to, or the nature, scope, size, scale, concentration, interconnectedness, or mix of, the financial activities conducted directly or indirectly by the company would pose a threat to the financial stability of the U.S., based upon the statutory factors, and the company is organized or operated in such a manner as to evade the application of Title I of Dodd-Frank.

During the second stage, the FSOC will look for six thresholds and an initial determination will be made if the company meets the total consolidated asset threshold plus one of the other thresholds:

- **Total consolidated assets**: $50 billion in global total consolidated assets for U.S. non-bank financial companies or $50 billion in U.S. total consolidated assets for foreign non-bank financial companies;
- **Credit default swaps outstanding**: $30 billion in gross notional credit default swaps outstanding for which a non-bank financial company is the reference entity;
- **Derivative liabilities**: $3.5 billion of derivative liabilities;
- **Loans and bonds outstanding**: $20 billion of outstanding loans borrowed and bonds issued;
- **Leverage ratio**: Minimum leverage ratio of total consolidated assets (excluding separate accounts) to total equity of 15 to 1; and
- **Short-term debt ratio**: Ratio of debt with a maturity of less than 12 months to total consolidated assets (excluding separate accounts) of 10 percent.

The proposed joint rule initially issued by the FDIC and the Federal Reserve would have required a SIFI to file a new Living Will when certain material events occurred. The FDIC Final Rule, however, reduces this burden and only requires each SIFI to file a notice[22] with the FDIC and the Federal Reserve within a time frame specified by the FDIC and the Federal Reserve (but not later than 45 days) after any event, occurrence, change in conditions or circumstances, or other change that results in, or could reasonably be foreseen to have, a material effect on the Living Will. The notice must identify any material event significant enough to merit modification of the Living Will. The SIFI must then revise the Living Will to take that event into account in the submission of the next annual Living Will. Any event that renders the Living Will ineffective, in whole or in part, is a material event.

Who is Covered in the UK?

The RRP requirements will apply to the following:

- All FSA-authorised banks and building societies regardless of size, including UK-incorporated subsidiaries of overseas banks; and
- Significant investment firms authorized by the FSA, specifically full scope BIPRU[23] 730k investment firms (firms with authority to deal on own account) with assets exceeding £15 billion.

The CASS RP requirement will apply to all firms subject to the FSA's client asset custody rules (CASS 6) and investment business client money rules (CASS 7). So some banks and significant investment firms may not need to prepare a CASS RP in addition to an RRP. The FSA is not calling for RRPs from UK branches of overseas entities, partly because the SRR tools are unavailable to resolve branches of overseas banks.

Who is Covered in the U.S.?

Pursuant to 12 C.F.R. 381.2(f), U.S. SIFIs will include:

- U.S. bank holding companies with at least $50 billion in consolidated assets (as determined based upon the average of the company's four most recent Consolidated Financial Statements for Bank Holding Companies as reported on the Federal Reserve's Form FR Y-9C);
- U.S. branches and agencies of international banks, where the consolidated worldwide assets of the international bank is at least $50 billion (as determined based upon the foreign bank's or company's most recent annual report or, as applicable, the average of the four most recent quarterly Capital and Asset Reports for Foreign Banking Organizations as reported on the Federal Reserve's Form FR Y-7Q); and
- Any non-bank financial company designated as a SIFI by the FSOC pursuant to Section 113 of Dodd-Frank.

According to the Federal Reserve, there were 34 U.S. bank holding company SIFIs as of 30 September 2011.[24] Likewise, it is estimated that approximately 98 U.S. branches and agencies of international banks will meet the U.S. SIFI definition because of the requirement to look to the consolidated worldwide assets of the head office of the U.S. branch or agency. Thus, the number of SIFIs whose head offices are outside the U.S. is almost three times the number of SIFIs located inside the U.S.

In addition, U.S. insured depository institutions with at least $50 billion in assets[25] (as determined based upon the average of the CIDI's four most recent Reports of Condition and Income or Thrift Financial Reports) must also file Living Wills. The FDIC estimates that 37 CIDIs are covered by the Interim Final Rule.

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[1] The FSB, an international board representing 24 countries and jurisdictions (including the UK and the U.S.), was set up to, among other things, develop and promote the implementation of effective regulatory, supervisory, and other financial sector policies.

[2] Meeting of Financial Stability Board – FSB Press Release Ref no. 43/2011 of 3 October 2011.

[3] Effective Resolution of Systemically Important Financial Institutions: Recommendations and Timelines – FSB Consultative Document, 19 July 2011.

[4] Annex 5 of the Consultative Document covers recovery and resolution plans.

[5] CASS refers to the FSA Client Asset sourcebook.

[6] 12 C.F.R. 381.

[7] 12 C.F.R. 243. Among other things, in the background section of the Federal Reserve's final rule, the Federal Reserve emphasized that resolution plans will enhance the FDIC's and the Federal Reserve's understanding of the U.S. operations of foreign banks and improve efforts to develop a comprehensive and co-ordinated resolution strategy for cross border firms.

[8] 12 C.F.R. 360. The Interim Final Rule was proposed under the authority of Section 9(a) Tenth, 12 U.S.C. 1819(a) Tenth, and Section 11(d) (1), 12 U.S.C. 1821(d) (1) of the Federal Deposit Insurance Act (FDIA).

[9] 11 U.S.C. 1101 et. seq.

[10] 12 U.S.C. 1821 and 12 U.S.C. 1823.

[11] 12 C.F.R. 360.10(c).

[12] The FDIC has entered into a memorandum of understanding with the Bank of England, and other international supervisors, to promote greater co-ordination in the resolution of cross-border firms. The FDIC is also collaborating with the Basel Committee on Banking Supervision, the International Monetary Fund, the European Forum of Deposit Insurers, the World Bank and the European Commission to develop and finalize the Methodology for Compliance Assessment of the Core Principles for Effective Deposit Insurance Systems.

[13] 12 C.F.R. 381.3(a) (i).

[14] 12 C.F.R. 381.3(a) (ii).

[15] 12 C.F.R. 381.3(a) (iii).

[16] 12 C.F.R. 381.4(a) (3).

[17] 12 C.F.R. 381.4(a) (3) (iii).

[18] 12 C.F.R. 1310.

[19] A non-bank financial company means a U.S. non-bank financial company and a foreign non-bank financial company: 12 C.F.R. 1310.2. A U.S. non-bank financial company means a U.S. organized or incorporated company (other than a bank holding company, a Farm Credit System institution and certain entities supervised by the Securities and Exchange Commission (SEC) or the Commodity Futures Trading Commission) that is predominately engaged in financial activities: 12 C.F.R. 1310.2. Foreign non-bank financial company means a company (other than a U.S. bank company or a company treated as if it were a bank holding company in the U.S.) that is incorporated or organized outside the U.S. and predominately engaged in financial activities: 12 C.F.R. 1310.2.

[20] 12 U.S.C. 5323.

[21] 12 C.F.R. 1310.11(b) has substantially similar requirements for foreign non-bank companies, but the focus is on the U.S. operations of the foreign non-bank companies. Similarly, 12 U.S.C. 5365(b)(2) provides that the Federal Reserve and the FDIC, with respect to Living Wills of foreign non-bank financial companies or any foreign-based financial company, give due regard to the principles of national treatment and equality of competitive opportunity and take into account the extent to which the foreign-based financial company is subject on a consolidated basis to home country standards that are comparable to those applied to financial companies in the U.S. This should be very helpful to many foreign-based financial companies located in Western Europe.

[22] 12 C.F.R. 381.3(b) (2).

[23] *See* the Prudential Sourcebook for Banks, Building Societies and Investment Firms.

[24] The Federal Reserve identifies the 50 largest U.S. bank holding companies on the National Information Center section of its website, under Banking Information and Regulation, Banking Structure at http://www.ffiec.gov/nicpubweb/nicweb/Top50Form.aspx.

[25] The Federal Reserve identifies the largest commercial banks under Banking Information and Regulation, Banking Data, Large Commercial Banks at http://www.federalreserve.gov/releases/lbr/current/default.htm. As of 30 June 2011, there were 33 large commercial banks with at least $50 billion in assets.