LIVING WILLS

Thomas F. Huertas and Rosa M. Lastra (*)

(*) Thomas F. Huertas is a partner in the risk practice at Ernst & Young (from January 2012) and was formerly Member, Executive Committee, Financial Services Authority (UK) and Alternate Chair, European Banking Authority. Rosa M. Lastra is Professor in International Financial and Monetary Law at CCLS, Queen Mary University of London. The opinions expressed in this article are the personal views of the authors and do not necessarily represent the views of their respective organisations. This article draws heavily on Huertas (2010).

This paper examines the notion of living wills, that is recovery and resolution plans, and considers development in the UK and the USA as well as international initiatives (in particular Financial Stability Board recommendations) and some EU proposals that represent the seeds of forthcoming legislation in this area. Living wills effectively tackle the too big to fail problem, by making sure that no institution is too big, too complex or too interconnected to fail and have become an essential element of the international framework to prevent future crises.

1 Introduction

Living wills are contingency plans that outline what a financial firm should do in the presence of a range of increasingly distressing scenarios. This article outlines the main elements of living wills, summarises how authorities globally are incorporating living wills into regulation and supervision and highlights further steps that need to be taken to assure that living wills contribute to financial stability.

Living wills have the same philosophy as other early intervention mechanisms, such as prompt corrective action, namely to act early so as to minimise costs to taxpayers and prevent "bail-outs", as well as to help limit and counteract the externalities that generally accompany bank and financial failures. The information embedded in a living will provides a degree of certainty and predictability that addresses the information asymmetries that characterise the business of banking and finance and that are a source of its vulnerability.

Living wills are a vital component of the comprehensive approach that is needed to prevent future crises.[1] They represent what amounts to a financial continuity plan for banks. Just as business continuity plans outline how a bank could continue to operate in the wake of a natural disaster, power failure or terrorist attack, living wills outline how a bank could continue to operate, if it came under extreme financial stress. As such, living wills contribute both to better supervision and to better resolution.

From the point of view of the firm, living wills are business plans for contraction (including the termination of the business in extreme circumstances). From the point of view of the authorities, living wills constitute an effective crisis management tool, one that is suited to address the problems of systemically significant financial institutions. As acknowledged, bank and financial crisis management comprises an array of official and private responses which extends beyond the insolvency proceedings that are the only tool typically available to deal with corporate bankruptcy in other industries. In addition to lender of last resort, deposit insurance, special bank insolvency proceedings and a variety of ex post rescue packages ("bail-outs"), the emphasis has now turned to early intervention procedures, preventive measures (enhanced macro and micro prudential supervision and counter-cyclical regulation) and contingency planning (stress testing and living wills) and "bail-in".

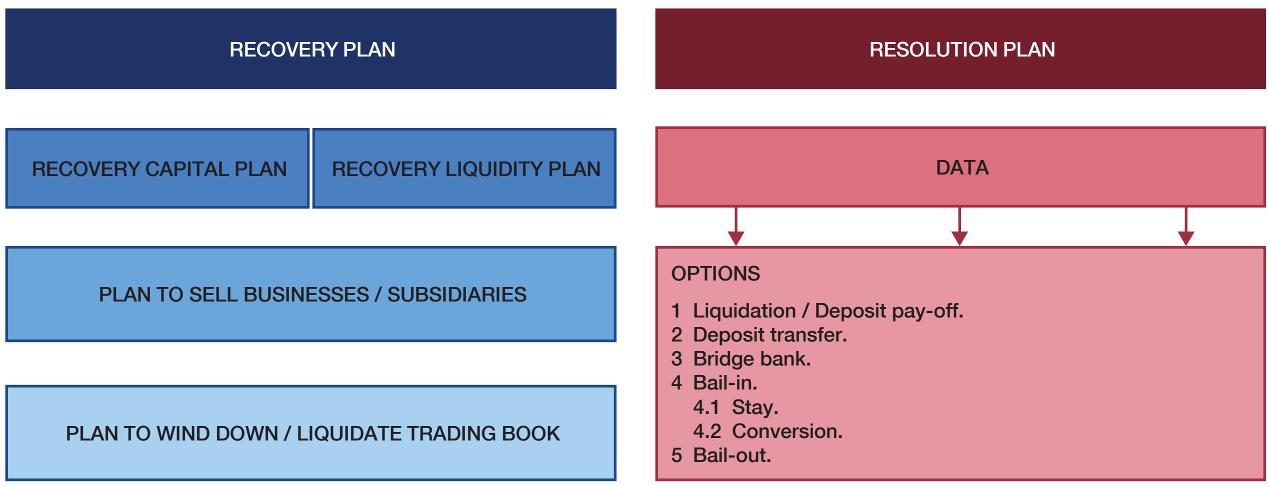
2 Living wills

Living wills have two parts:

1. A recovery plan which outlines the steps the bank itself could take to assure that it maintained adequate capital and liquidity, even if it came under extreme stress. This recovery plan is for the bank to develop and "own". The supervisor

1 For a general description of this comprehensive approach see Huertas (2011a).

RECOVERY AND RESOLUTION PLAN ("LIVING WILLS") FIGURE 1



assesses the plan and determines whether or not the plan provides the bank with sufficient resiliency. If it does not, the supervisor may take steps to induce the bank to improve its resiliency.

2 A resolution plan which outlines the steps the authorities would take, if the bank were to fail to meet threshold conditions and the supervisor determines that the bank should be put into resolution. The resolution plan is for the authorities to develop and "own". The bank merely provides data to the authorities. The authorities use that data to develop a resolution plan that includes the method(s) they would employ to resolve the bank and how they would implement those methods so that resolution could proceed rapidly.

Regulators in many countries are now requiring banks to develop living wills and submit them to supervisors for review. The United Kingdom has been at the forefront of policy and regulatory changes to advance the concept of living wills, which was first proposed in January 2008 in a Treasury consultation paper entitled "Financial Stability and Depositor Protection: Strengthening the Framework". For some time the Financial Services Authority (FSA) has been requesting institutions to prepare living wills. In August 2011 the FSA published its combined consultation and discussion paper (CP11/16) setting out detailed proposals for recovery and resolution planning for deposit taking institutions and certain major investment banks.[2] With the forthcoming dismantling of the FSA (due to take place at the beginning of 2013), the tasks concerning living wills will be part of the remit of the Prudential Regulatory Authority. The Bank of England and the FSA published a document in May 2011, "Our approach to Banking Regulation"[3] in which they emphasised that "resolvability" is a key element of UK prudential regulation and in particular in considering the appropriateness of firm structures.

On July 19, 2011 the Financial Stability Board and the Basel Committee on Banking Supervision released a consultative document on "Effective Resolution of Systemically Important Financial Institutions. Recommendations and Timelines",[4] setting out proposed

2 http://www.fsa.gov.uk/pubs/cp/cp11_16.pdf.
3 http://www.fsa.gov.uk/pubs/speeches/boe_pra.pdf.
4 http://www.financialstabilityboard.org/publications/r_110719.pdf.

measures to address the systemic and moral hazard risks posed by systemically important financial institutions (SIFIs). The measures implement the framework contained in the FSB's recommendations endorsed by the G20 Leaders in November 2010. The proposed measures comprise four key building blocks: (1) Strengthened national resolution regimes that give a designated resolution authority a broad range of powers and tools, including statutory bail-in, to resolve a financial institution that is no longer viable; (2) Cross-border cooperation arrangements in the form of institution-specific cooperation agreements, underpinned by national law, that will enable resolution authorities to act collectively to resolve cross-border firms in a more orderly, less costly, way; (3) Improved resolution planning by firms and authorities based on ex ante resolvability assessments that should inform the preparation of Recovery and Resolution Plans;[5] and (4) Measures to remove obstacles to resolution arising from complex firm structures and business practices, fragmented information systems, intra-group transactions, reliance on service providers and the provision of global payment services.

These measures address problems that became apparent with the failure of Lehman Brothers. Efforts to resolve this firm were greatly complicated by a lack of preparation. Basic information was missing about organisational structures and relationships between subsidiaries. This made it difficult to act quickly, to anticipate the effects of different actions in different jurisdictions, and to resolve conflicts between subsidiaries and jurisdictions. Much economic value was lost as a result. When a firm falls into distress, the authorities and the firm need detailed contingency plans to implement rapid, well-planned measures to ensure that the firm can continue to perform critical functions, or wind them down if necessary, without spill-overs that damage the wider system. An adequate, credible RRP should be required for any firm which is assessed by its home authority to have a potential impact on financial stability, in the event of liquidation of that firm. The SIFI Recommendations call for RRPs to be put in place for all G-SIFIs. Authorities and SIFIs are currently working together to create RRPs for each firm. RRPs should set out in advance the measures, in the event of a crisis, that a firm could take to recover as a going concern or else that the authorities could take to resolve it in an orderly way. RRPs and resolvability assessment complement each other: RRPs should use as a base the conclusions of the resolvability assessments discussed above; indeed, an important benefit of the process of developing a plan is to identify actions that firms need to take to make themselves resolvable. RRPs of G-SIFIs will be reviewed, subject to adequate confidentiality agreements, within the institution's Crisis Management Group at least annually. To ensure the involvement of the key decision makers and keep them informed, the adequacy of RRPs of G-SIFIs should also be the subject of a formal review, at least on annual basis, by top officials of home and relevant host supervisory and resolution authorities, where appropriate, with the firm's CEO.

In the US, the Dodd-Frank Act 2010[6] has established the Financial Stability Oversight Council (FSOC), to address macro-prudential supervision and living wills are one of the tools foreseen to enhance financial stability. On July 26, 2011, the FSOC released its first Annual Report. As directed by section 112 of Dodd-Frank, the Annual Report included a set of recommendations directed at both market participants and regulatory agencies. The recommendations included: Heightened Risk Management and Supervisory Attention, Reforms to Address Structural Vulnerabilities, Reform of the Housing Finance System and Coordinated Implementation of Financial Reform.

5 Ibid.
6 Dodd-Frank Wall Street Reform and Consumer Protection Act (Pub. L. No. 111-203, H. R. 4173).

Amongst the heightened standards that the Federal Reserve System was required to promulgate (within 18 months from effective date of the Act, unless otherwise specified) the following are noteworthy from the point of view of this paper: resolution plans ("living will") and credit exposure reporting requirements, stress test requirements, prompt corrective action requirements and contingent capital requirements.

On September 13, 2011, the Federal Deposit Insurance Corporation approved a final rule[7] on resolution plans under Section 165(d) of the Dodd-Frank Act, which must still also be approved by the Federal Reserve, and an interim final rule[8] requiring insured depository institutions with $50 billion or more in total assets to submit resolution plans. Generally, the FDIC and the Federal Reserve have agreed on an integrated single plan approach to the resolution plans, and the two resolution plan rules are intended to work in tandem. Included with this memo is a comparison chart of the different information requirements in the Section 165(d) and insured depository institution resolution plan rules which cuts through the different wording and ordering in the rules.

Though the earliest resolution plans will be due by July 1, 2012, the FDIC and the Federal Reserve have adopted an approach of staggered initial submissions to allow some firms to submit their resolution plans later than others based on a test linked to total nonbank assets. Moreover, resolution plans will be built on an iterative, tailored approach. Plans will accordingly develop over time and in successive submissions, and plans will vary depending on the size and complexity of the covered company or covered insured depository institution. U.S. regulators have aligned the timing of resolution plan submissions with the timing of resolution plan submissions as suggested by the Financial Stability Board,[9] thus putting in place a structure that will permit most foreign-headquartered financial institutions operating in the U.S. to work first with their home country regulators for an entire yearly cycle and then, after one cycle with their home country regulators, to submit resolution plans to the U.S. regulators.

The concept of living wills has also found favour in some recent initiatives in the EU. Though there is currently no EU framework for managing crises in the banking and financial sector, the EU Commission has published a number of documents that constitute the seeds of legislative reform in this area. In October 2009, the Commission issued a communication on an EU Framework for Cross-Border Crisis Management in the Banking Sector[10] and invited public consultation. The communication addressed: (1) early intervention (i.e., actions by supervisors aimed at restoring the stability and financial soundness of an institution when problems appear, together with intra-group asset transfers between solvent entities for the purposes of financial support. These actions would be taken before the threshold conditions for resolution are met, and before the institution is or likely to become insolvent); (2) resolution (i.e., measures taken by national resolution authorities to manage a crisis in a banking institution, to contain its impact on financial stability and, where appropriate, to facilitate an orderly winding up of the whole or parts of the institution, such as a temporary "bridge bank"); and (3) insolvency (including reorganization measures and winding-up procedures).

7 http://www.fdic.gov/news/board/Sept13no4.pdf.

8 http://www.fdic.gov/news/board/Sept13no6.pdf.

9 Above note 4. By December 2011, the first drafts of the recovery plans should be completed. By June 2012, the first drafts of the resolution plans should be completed. By December 2012, both the recovery plans and the resolution plans should be completed. See Davis Polk, "Credible Living Wills Under the US Regulatory Framework", 19 September 2011.

10 Commission Communication on "An EU Framework for Cross-Border Crisis Management in the Banking Sector", 20.10.2009, COM (2009) 561.

In May 2010 the Commission issued a communication on Bank Resolution Funds.[11] In October 2010, the Commission issued another Communication on an EU framework for Crisis Management in the Financial Sector in October 2010 for all financial institutions, credit institutions, investment firms, insurance companies, investment funds and Central Counterparties.[12] No entity should be "too big too to fail." Ailing institutions of any type and size, and in particular systemically important institutions, should be allowed to fail without risk to financial stability whilst avoiding costs to taxpayers. The crisis management framework comprises:

- preparatory and preventative measures such as a requirement for recovery and resolution plans ("living wills") and powers for authorities to require banks to make changes to their structure or business organization where such changes are necessary to ensure that the institution can be resolved;

- powers for supervisors to take early action to remedy problems before they get out of hand such as the power to change the managers; and

- resolution tools which empower authorities to take the necessary action, where bank failure cannot be avoided, to manage that failure in an orderly way such as powers to transfer assets and liabilities to a bridge bank.

This communication was followed by a consultation on Technical Details of a Possible EU Framework for Bank Recovery and Resolution on January 6, 2011.[13] A broad range of issues was considered, from prevention and early intervention to bank resolution measures and financing arrangements. This consultation set out technical details of the framework outlined in the Commission's Communication of October 2010. The consultation closed on the 3 March 2011.[14] A draft directive expected to have been published in the fall of 2011 has been delayed given the pressing problems posed by the sovereign debt crisis in Greece and its contagion effects upon other sovereigns on the one hand and European banks on the other hand. In spring 2010 the Commission established a group of insolvency law experts to assist with the preparatory work. A report by the European Parliament has also made important recommendations on Cross-Border Crisis Management in the Banking Sector (the Ferreira Report).

3 Recovery plans

Under a recovery plan the bank is forced to think through in advance what it would do, if the bank were to fall under extreme stress. Recovery plans build on two things that banks should be doing in any event – capital planning and liquidity planning. Banks are already required to plan for how they would maintain their capital and liquidity above certain threshold levels even under a severe stress scenario.

What recovery plans do is ask how the bank would maintain adequate capital and adequate liquidity if the stress turns out to be even greater than postulated and/or the bank's primary course of action under the postulated stress scenario turns out to be insufficient. In credit terms, the recovery plan asks the bank to tell the supervisor what is the bank's second way out. This enables the supervisor to determine how resilient the bank is likely to be and, if

11 Commission Communication on "Bank Resolution Funds", 26.5.2010, COM (2010) 254 Final.
12 Commission Communication on "An EU framework for Crisis Management in the Financial Sector", 20.10.2010, COM (2010) 579 Final.
13 DG Internal Market and Services Working Document "Technical Details of a Possible EU Framework for Bank Recovery and Resolution", Brussels, 6.1.2011.
14 See generally http://ec.europa.eu/internal_market/bank/crisis_management/index_en.htm.

need be, to induce the bank to take steps to improve its resiliency. The review of the bank's recovery plan is therefore an integral component of a more forward looking and pro-active approach to supervision.

The options proposed under a recovery plan should be judged under four criteria:

- They should be capable of execution within a reasonably short time frame, certainly no longer than six months and ideally within three. It is especially advantageous for banks to have options that can be executed within a very short time frame with a high degree of certainty. Options that carry a high degree of execution risk and/or take a long time to implement are unlikely to lead to a successful recovery.

- They should be sizeable, both individually and in aggregate, so that the plan has a reasonable chance of being able to turn the institution around. Actions have to have a material impact on the institution, if the institution is to achieve a turnaround.

- They should be diverse, so that the bank has a range of options to choose from. The actual choice will depend on the circumstances prevailing at the time the institution gets into trouble.

- They should be credible to key stakeholders – shareholders, debt holders, depositors, counterparties, central banks and supervisors. Accordingly, the recovery plan should address how the bank would handle communication with and disclosure to those stakeholders and the public at large so as to maintain confidence in the institution during the recovery process.

Firms that meet these four criteria are likely to be resilient even under extreme stress. Those that do not will probably be vulnerable. This is the key assessment or judgment for the supervisor to make when reviewing the bank's recovery plan. For banks that are not likely to be resilient the supervisor will want to engage in a dialogue with the bank's management and board of directors as to how the bank might be made more resilient, and the supervisor will want to be cautious about approving business expansion plans (particularly acquisitions) until the bank has become resilient.

Even for banks that are resilient, a recovery plan will necessarily require the bank to consider in advance some tough strategic choices. To survive, the bank may be forced to do things that it would prefer not to do in normal times, such as issuing new equity capital, selling/running down certain businesses or even selling the firm itself. But it is certainly wise to think through in advance what could be done in extreme stress. This not only forces the bank's board and management to consider that extreme stress could occur, but it lays out what actions the bank could take to rectify the situation. Just as one wants to know well in advance of the fire what the evacuation procedures are, so too does one want to know what the bank would do if extreme financial stress were to materialize.

Raising additional capital. In terms of capital, a recovery plan forces a bank to think through the steps that it would take to generate additional capital in a time of extreme stress. Although a bank in stress may be able to go to investors to raise new capital, it is unlikely to be able to do so successfully within the time frame required, unless it already maintains an on-going and deep relationship with the prospective investors. The bank also has to recognise that investors are few and far between who are able and potentially willing to put very large amounts of capital on the line at short notice. These investors are likely to have the pick of possible transactions, so getting new capital for a bank in trouble may be especially hard, if there are other banks in slightly less troubled situations which are looking to raise money at the same time. Even if the bank does succeed in getting new capital, it is likely to be very expensive indeed and could pose significant dilution to existing shareholders.

Consequently, banks may wish to give greater consideration to raising contingent capital whilst they are still some distance from real trouble. Such capital takes the form of debt or preferred stock at inception, but converts to core Tier 1 capital if a certain threshold is passed. Provided the trigger for conversion into core Tier 1 capital assures that conversion will in fact take place when the bank needs new capital, contingent capital provides both certainty of execution (the money is already in the door) and speed.[15]

Raising additional liquidity. In a crisis liquidity is the lifeblood that keeps a bank alive. So any recovery plan has to include a robust contingent liquidity plan.

Banks are already required to develop a contingency funding plan as part of their normal liquidity management, and this plan is certainly the foundation for the liquidity aspects of the recovery plan. From the vantage point of a recovery plan, it can be assumed that the bank is already under extreme stress, so the questions that are likely to feature prominently in the liquidity aspects of the recovery plan are the following:

- To what extent does the bank have back-up sources of liquidity from the private market? Are these contractual and can the counterparty be relied upon to perform promptly?

- To what extent is the bank likely to have available the necessary collateral that may be required to secure additional funding from private sources? Does the bank have a *collateral budget* that shows the amount and types of collateral that funds providers will require? In particular, does the bank have a schedule of the additional collateral that it would be required to pledge to current market counterparties if the bank is downgraded?

- At what point does the bank envisage that it would have to access routine sources of central bank funding? Does the bank have in place the necessary legal agreements in place to borrow from the central bank(s)? Is the bank likely to have sufficient unencumbered eligible assets to secure such borrowing from the central bank(s)? Has the bank prepositioned such assets with the central bank and/or made arrangements to rapidly transfer/pledge such assets to the central bank? If the bank does obtain funding from the central bank, what are the prospects that the bank can repay that financing with a relatively short (one month) horizon?

15 The notes carry a very significant spread (several percentage points) above the bank's senior debt. This spread can be thought of as an insurance premium that the bank pays to investors to have them standing ready to provide new equity capital at a predetermined price should the bank have to raise new equity. Effectively, contingent capital is financial continuity insurance.

Sale or run down of business. If the sale of one or more business units is to be part of a credible recovery plan, the bank should be able to demonstrate that the unit in question is readily saleable.[16] This is much more likely to be the case if the business is:

– housed in a separate subsidiary (so that the ownership of the business can be sold through the sale of the stock in the subsidiary to the third-party buyer);

– operationally separable from the rest of bank, so that the buyer would not have to rely upon the systems of the seller; and

– self-sufficient from a funding and liquidity point of view.

In addition, the concept of "readily saleable" also depends on the need to obtain shareholder and regulatory approval and the likely time required to obtain such approvals.

Ideally, the businesses to be sold are strong, healthy businesses. These are likely to be attractive to third-party buyers and more likely to sell quickly without the need for vendor finance. It is much more problematic to sell poorly performing businesses. The seller may even need to pay the buyer to take the business. There are circumstances where it may make sense to do just that, but such sales are not likely to boost confidence among market participants about the firm's overall future.

Should a bank decide as part of its recovery plan that it needs to exit a business, it is important that the bank do so in a manner that boosts, rather than undermines, confidence. It is generally counterproductive for a bank to simply walk away from an affiliate where the bank has ownership and/or management control. The lack of willingness to support an affiliate may be deemed as a lack of ability to do so and undermine the confidence of the market in the group as a whole. Rather than let the subsidiary fail, the group will generally find it preferable to wind the subsidiary up gradually, working down the assets and reducing the liabilities over time whilst maintaining the subsidiary as a going concern. Absent nationalisation, expropriation or some other extraordinary event that differentially destroys a particular subsidiary, it is usually a very bad idea for a major international bank even to contemplate walking away from a wholly owned bank subsidiary.[17]

Running down the book. In developing a recovery plan banks will want to give particular attention to how quickly cash can be generated from various businesses, if the bank shifts from normal business more toward a run-off mode. Of course, doing so will reduce on-going income and may require the bank to take capital losses, and this would have to be weighed against the benefits of more immediate increases to liquidity that could result

16 Although the bank would not need to maintain an ongoing data room for the businesses that it would potentially put up for sale, it would need to assure itself and its supervisor that it could quickly assemble the type of data that a prospective buyer would want to review as part of due diligence prior to completing a purchase of the business.

17 There are certainly shades of grey that can be applied to the above statements. Banks could contemplate a spin- off of a business to the bank's own shareholders (but this will generally require some assurance that the newly spun off entity can continue to fund itself once outside the group). For cases (such as structured investment vehicles [SIVs]) where the bank clearly indicated to investors that the vehicle was separate from the bank, it has been possible in some cases for the bank to liquidate a vehicle over which it had management control, provided the bank took steps to assure that any losses were imposed on investors in the vehicle in strict seniority. For example, some banks decided during the crisis to liquidate the SIVs that they had sponsored rather than take them on balance sheet. In such liquidations investors in the junior securities of the SIV took losses. But even in these cases, the decision to liquidate was taken after negotiation with the investors in the junior securities.

from shifting toward run off mode. In an active market widening the spread that the bank charges on roll-overs and/or tightening standards will cause borrowers to finance or refinance elsewhere, reducing the book that the bank has to finance and the capital that the bank has to keep. Similarly, restricting trading limits and raising liquidity charges to the trading desk can induce trading businesses to run down the trading book, potentially reducing positions that have to be financed and capital that has to be posted.

Arbitrage books may be particularly good candidates for creating capital and/or liquidity from a "run-off", as they tend to be low-margin businesses with limited customer impact. And, if such businesses cannot be unwound under stress in a manner that does in fact generate capital and liquidity for the bank, it may be a sign that the business is not being charged a cost of capital and/or funding commensurate with the risk that such books pose to the bank. Indeed, if trading book positions cannot be unwound over a fairly limited time frame (say 60 days), one may question why they are in the trading book at all.

The state of the overall market significantly affects the likelihood that a run-off strategy can succeed. If a bank gets into trouble on its own, it is far more likely to be able to execute such a run-off successfully. A classic example is the ability of Salomon Brothers to run down its balance sheet by some 35% within the course of six weeks in 1991 following severe sanctions by the US government in response to Salomon's attempt to corner the US government bond market. But even in this recent crisis major banks have succeeded in dramatically reducing the size of their balance sheets, largely by restricting the size of their trading books.[18]

Sale of the entire business. Finally, the recovery plan should give some consideration as to whether the entire business could be sold to a third party. Many of the issues raised above in connection with the sale of individual businesses will also apply to a sale of the whole business.

Two additional issues stand out – antitrust and completion risk. The most likely candidate to buy a large, complex bank at relatively short notice is another large complex bank. That poses potential antitrust issues, and these need to be considered in reaching an evaluation as to whether such a sale could be contemplated in the recovery phase, only in the resolution phase or not at all.

Completion risk is higher with respect to the sale of the entire firm. The closer the selling firm is to resolution, the more likely it is that some type of liquidity backstop and/or guarantee[19] of the selling firm's transactions by the buyer will be required. Such a guarantee may require the approval of the shareholders and/or regulators of the acquiring firm.[20] If so, the selling firm would be placed in limbo whilst the acquiring firm sought the approval of the shareholders for the guarantee – hardly the most appealing prospect either to the shareholders of the acquiring firm or the creditors of the selling firm. So selling the entire firm to a third party is practically speaking only an option if the sale process starts early enough (so that a guarantee of the obligations of the seller is not required) and/or the time required for regulatory and shareholder approval is kept to a minimum.

18 For example, in the year ending 30 November 2008 Morgan Stanley reduced total assets by 37% (see http://www.morganstanley.com/about/ir/shareholder/10k113008/10k1108.pdf, p. 79) and Goldman Sachs by 21% (see http://www2.goldmansachs.com/investor-relations/financials/archived/annual-reports/financial-section-2008.pdf, p. 61).

19 An example is the guarantee that JPMorgan Chase gave in March 2008 to facilitate its acquisition of Bear Stearns [see Cohan (2009), pp. 117-120].

20 This would have been the case had Barclays offered to guarantee the obligations of Lehman Brothers in September 2008 [see Paulson (2010), pp. 202-203].

In sum, recovery plans are as much good management as sound supervision. They highlight the steps that the bank would need to take to cope under extreme stress. If these steps would be sufficient to allow the bank to survive, the bank can be said to be resilient and planning can focus on how and when the steps should be implemented. If, however, the plan indicates that the steps are unlikely to be sufficient, planning should focus on the measures that will be required in order to make the bank resilient under extreme stress.

4 Resolution Plans

Resolution plans differ from recovery plans. Banks can create and implement their own recovery plans. In contrast, resolution plans are for the authorities to develop and implement. What living wills ask banks to do in advance is to make preparations so that the bank would be able to furnish at short notice the information that the authorities would need in order to make a choice among the resolution methods open to the authorities to use, should the condition of the bank deteriorate to the point where the authorities have to intervene.

In forming a resolution plan, authorities need to focus on the steps they could actually take under current legislation, if the bank were to fail to meet threshold conditions and be put into resolution. Effectively, the authorities are looking to make a preliminary assessment of the resolution method that they would employ, if the bank were to fail, and to figure out in advance the steps that they would need to take in order to be able to implement that method rapidly, should the bank actually fail.

In a paper published by UK law firm Slaughter and May of October 2011 ("Unfinished testaments: The blueprints for recovery and resolution"), Charles Randell et alii argue that "Resolution powers are to financial institutions what emergency powers are to citizens – the suspension or override of 'normal' rights, including the detention or disposal of businesses swiftly and without trial (generally, affected parties will not be able to use the courts to block or delay regulatory action). Resolution, thus, potentially involves significant regulatory or governmental interference with legal rights, whether statutory or contractual".

If a firm is beyond recovery, it may need regulatory intervention to arrange an orderly resolution. There are no easy choices when it comes to intervention/resolution of bank, especially a large, complex bank with significant international branches and/or subsidiaries. A decision to inject equity and avoid resolution entirely solves the immediate problem, but it poses significant immediate and even more significant potential costs in that it destroys the public finances, undermines market discipline and sows the seeds of future crises. A decision to place the bank under temporary public ownership may avoid the immediate cost of an equity infusion, but could require the government to issue a blanket guarantee of some or all of the bank´s liabilities. That could adversely affect the government's own credit rating and borrowing costs, unless the period of temporary public ownership were very brief indeed. A decision to resolve the bank through deposit transfer and/or bridge bank limits the scope of any government guarantee but may involve severe disruption to the credit and/or securities markets as a result of the bank's becoming a gone concern. A decision to pay off insured deposits and liquidate the bank requires no guarantee but may require significant amounts of immediate funding and will pose significant operational risks. Indeed, panic could result, if a pay-off is attempted but fails to complete within a brief time frame.

These are choices with massive implications for the bank in question and society at large, and they must be made quickly. Indeed, the longest period of time that the authorities are likely to have to make a decision is the roughly 36 to 48 hours between the close of business on a Friday in Europe and North America and the opening of markets in Asia when it is still Sunday evening in North America. To make such decisions in that time frame the authorities must have a framework for making the decision and information on which to base the decision. They should also think through in advance some of the issues that are likely to arise in connection with communicating the decision to key stakeholders and to the public at large.

Framework for decision. Conceptually, there is consensus that the choice of resolution method should be based on some type of cost-benefit test. For systemic institutions this should take into account overall costs and benefits for society as a whole, rather than narrow considerations of least cost to the deposit guarantee scheme. With respect to who makes the decision, there is also, as a practical matter, consensus that the decision with respect to resolution method for large, systemically important institutions is one for governments to make and that the decision may ultimately be made by the finance minister in consultation with the head of government. Supervisors and central banks may provide advice with respect to the decision that should be taken, but the decision is ultimately one for governments to take at the highest level.

Information requirements. To make this assessment the authorities require certain information from the bank and/or require assurance that certain information would be available on short notice, if the bank were to fail. By asking banks to outline such information and to determine in advance that they could in fact generate the details of such information on short notice, the authorities can reduce or possibly even eliminate the possibility that the intervention/resolution of a troubled bank would require the injection of taxpayer funds and/or the extension of government guarantees, such as was judged to be required many times during the crisis.

The type of information the authorities require is the same type of information that an insolvency practitioner would ideally like to have upon the commencement of an administration process for a firm. This includes the legal vehicle structure of the banking group, a mapping of its principal businesses against that legal vehicle structure and identification of financial and operational dependencies among various elements of the group. It also includes information concerning the bank's membership in payments, clearing and settlement infrastructures, information concerning the segregation of client assets and the procedures by which such segregated client assets could be transferred to third parties. The authorities will need information concerning the bank's deposit base: what is insured and what is not, as well as what is the maturity structure, terms and conditions of the deposits. Finally, the authorities will require information on any instruments that could be written down or converted into common equity at the point at which the bank becomes non-viable in private markets.[21]

This is exactly the information that the resolution plan requires the bank to be able to generate at short notice for the authorities. There is no need for the bank to create a real time data room for such information, but there is a need to be sure that the authorities could readily access such information, if the need arose, much the way that the bank needs to be sure that it can access relevant information about its facilities to assure business continuity in the event of some physical disruption. Accordingly, the authorities will want to assure that banks have the capability to generate such information in short order, and at some point will want to run through a "fire drill" to assure that the bank can in fact do so and at some point (e.g. when the institution comes under such stress that it has to initiate is recovery plan) the authorities will demand that the troubled bank populate

21 Under Basel 3 non-core Tier 1 and Tier 2 capital instruments should be subject to write down or conversion into common equity when the bank becomes non-viable in private markets.

a data room with the relevant information, so that the authorities can engage in contingency planning in the event that intervention/resolution becomes required.

Therefore, in reviewing the bank's resolution plan, the authorities are likely to give particular consideration to the bank's overall structure. Are businesses easily separable, in that they are exclusively or predominantly booked in separate legal vehicles, where the sale of stock in the legal vehicle effectively constitutes a sale of the business? Or are the bank's businesses booked across a variety of legal vehicles, so that each legal vehicle contains many businesses, and each business is booked in many legal vehicles?[22] The former allows for easier and more rapid sale of separate businesses to third parties; the latter does not, and may imply that groups with such structures would need higher capital and/or liquidity requirements to assure that they remain further away from the point of intervention/resolution.

In formulating the resolution plan the authorities will wish to give consideration to the possible knock-on effects that the resolution may have upon other financial institutions and the economy at large. Three elements deserve particular emphasis: client assets, infrastructures and international ramifications.

If clients lose access to their funds whilst the troubled bank is being resolved, this poses liquidity issues for the client and exposes the client to the risk of market losses whilst the client is unable to trade the instruments frozen at the firm in resolution. This could be a source of contagion from the failed institution to others. Regulators need to assure that banks properly segregate client money and that there are procedures in place whereby the segregated client money could be transferred to third parties at short notice if the bank were to fail [Financial Services Authority (2011)].

In addition to information requirements for the banks themselves, the authorities will also need to assure that they have to hand information from the infrastructures and deposit guarantee schemes of which the bank is a member. In particular, the authorities need to know whether the major infrastructures in which the troubled bank is a member are robust enough to withstand the failure of the troubled bank. If the infrastructure is not robust, the failure of the troubled bank to meet its obligations to the infrastructure could cause the infrastructure itself to collapse and transmit the failure of the troubled bank to the other members of the infrastructure.[23] Similarly, the authorities need to know whether the deposit guarantee schemes in which the troubled bank is a member are in a position to pay out insured depositors promptly in the event that the troubled bank fails and the authorities elect to liquidate the bank and pay off the insured deposits. As indicated above, there is no better way to assure financial panic than to have the deposit guarantee scheme fail to meet its obligations.[24]

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22 Note that this formulation is agnostic with respect to the assets that deposits finance. The key point is separability of the business, not the assets financed by the deposits. Indeed, if anything there would potentially be an argument for saying that deposits should go to finance assets that can be readily marked to market. That would facilitate due diligence of the assets that would be transferred with the deposit book.

23 Accordingly, the authorities need to continue to work with infrastructures and the banks that use such infrastructures in order to strengthen the resiliency of the infrastructures. Payment, clearing and settlement infrastructures are single points of failure in the financial system. Provided they are robust, they serve as circuit breakers to limit the risk of contagion from the failure of one bank to another. If, however, they are not capable of withstanding the failure of at least one (and preferably two or more) of their largest counterparties, infrastructures would be a very powerful transmission mechanism for financial instability. Much has been done over the past two decades to strengthen infrastructures [CPSS-IOSCO (2011)]. This progress needs to continue.

24 Accordingly authorities need to continue to improve the operational and funding arrangements for deposit guarantee schemes so that they are able to pay out insured deposits promptly [Huertas (2011a), pp. 145-156].

Finally, for internationally active institutions, the authorities in the home country will need to coordinate their planning with that host countries conduct so that a common plan can be developed, taking into account the status of the bank in each of the countries in which it operates as well as legal and regulatory requirements. This will allow the authorities to plan how they would communicate in crisis with each other and with the market. It would also potentially allow the authorities to remove or mitigate obstacles to rapid resolution – such as the need to approve a change in control – as well as to give consideration to weightier and more controversial issues, such as burden sharing. Accordingly, the Financial Stability Board has recommended that institution-specific cross-border stability groups develop resolution plans for each global systemically important financial institution by year end 2012 [Financial Stability Board (2011)].

Communication issues. As with recovery plans, communication is an important aspect of resolution plans, before, during and after a decision is made with respect to the resolution of a large, systemically important banking group.

What resolution plans indicate to the market is that authorities are taking steps to assure that they will not be "forced" to bail out or rescue large firms, so that no firm is necessarily too big to fail. This can already have a salutary effect on market discipline. Indeed, Moody's has already alerted investors to the fact that resolution plans "would remove the necessity to support banks as banks would no longer be too interconnected or complex to fail. This could potentially result in ratings downgrades where ratings currently incorporate a high degree of government support" [Croft and Jenkins (2009)].

As the point of intervention nears, communications become critical. The resolution plan needs to think through in advance the persons at the firm, relevant regulators and third parties who would be required to make the relevant decisions in connection with the intervention/resolution method chosen, the documentation and procedures that would have to be followed and the way in which decisions would be communicated to stakeholders (e.g. other regulators, market participants, media) who were not part of the decision process. Indeed, much of the impact of a resolution decision may depend on the way the public perceives the situation.

Overall, the formulation of a resolution plan will enable the authorities to determine whether a bank is "safe to fail," i.e. whether the bank can be resolved without taxpayer support and without undue harm to the financial system and the economy as a whole. Ideally, the authorities would be able to devise a resolution method that would allow for maximum continuity in customer-related activities whilst assuring that capital providers remained exposed to loss and avoiding the need to give widespread or long lasting guarantees of the bank's liabilities. This would avoid the problems that arise from abruptly unplugging a bank from payments, clearing and settlement infrastructures. It would also allow for deposit accounts to be maintained, and revolving credit arrangements to continue functioning. In effect, such a solution would amount to an accelerated, but solvent wind down of the bank through rapid sales of certain aspects of the bank's activities to third parties and through a rapid reduction in certain activities. That would leave customers largely unaffected, but impose losses on investors/capital providers. This is much more likely to be the case if critical portions of the institution can be kept as going concerns for even a few days.

If the review determines that the bank is not "safe to fail," the authorities will have to consider three possible courses of action:

1. Change the law. If a country does not have a special resolution regime, or if that regime does not contain all appropriate resolution methods, the authorities should give consideration to changing the law. Countries that do not have a special resolution regime should implement one, and resolution regimes should include a full complement of resolution methods, including bridge bank and bail-in [Financial Stability Board (2011)]. Consideration may also be given to requiring banks to have a minimum amount of "back-up" or contingent capital outstanding, so that such capital could be written down or converted into common equity in the event that the bank fails to meet threshold conditions [Huertas (2011a), pp. 204-205; Huertas (2011b)].

2. Change the firm. If a firm is not resolvable in its current form, consideration should be given to requiring the firm to make changes to its structure and/or business practices (e.g. with respect to inter-affiliate transactions and cross-guarantees) so that the firm would become resolvable. However, such demands for change at the firm level are not a substitute for changing the law.

3. Charge the firm. If a firm remains unresolvable, consideration should be given to imposing further requirements on the firm to reduce the probability that the firm will fail [Huertas (2011a), p. 203].

It is interesting to observe that the Vickers Report (the report of the Independent Commission on Banking[25]) published on 19 September 2011 suggests changes to the law and changes to the firm in its recommendations. The most controversial and talked about part of the Vickers Report is the proposed structural separation between domestic retail services and global wholesale and investment banking operations. This separation has been referred to by some as the need to separate "casino banking" from "utility banking". Since a return to Glass-Steagall type of legislation with a clear legal divide between investment banks and commercial banks appears impractical (the business of banking and finance has substantially changed over the last decades and today wholesale funding is often more important than retail funding, certainly for banks in Europe), how should the line be drawn between retail banking and wholesale/investment banking? Narrow banking and mutual fund banking are two different ways of tackling this quandary, as is – in a more limited fashion – the Volcker Rule embedded in the Dodd-Frank Act 2010 in the USA. According to the Vickers report, the best policy approach is to require retail ring-fencing of UK banks. The report argues that this type of structural separation should make it easier and less costly to resolve banks that get into trouble, should help insulate retail banking from external financial shocks, thus diminishing problems arising from global interconnectedness, and should increase the resilience of the UK retail banking system. The report has been embraced by the Government and can thus be considered as a blueprint for legislative reform in this area.

5 Conclusion

Notwithstanding the difficulties inherent in keeping the information to be included in a living will relevant and up to date and the tension between confidentiality and disclosure, living wills form an important part of the overall programme to strengthen the financial system and prevent future crises. They are part and parcel of better supervision and they will lead to better resolution.

25 The Independent Commission on Banking was established by the Government in June 2010 to consider structural and related non-structural reforms to the UK banking sector to promote financial stability and competition. The Commission was asked to report to the Cabinet Committee on Banking Reform by the end of September 2011. Its members, Sir John Vickers (Chair), Clare Spottiswoode, Martin Taylor, Bill Winters and Martin Wolf, published an Interim Report in April 2011 and the final report in September 2011. See Lastra, "Vickers is home, but not yet dry", Parliamentary Brief, 7 October 2011. See http://www.parliamentarybrief.com/2011/10/vickers-is-home-but-not-yet-dry.

Recovery plans are well within the scope of banks to design and implement. Indeed, banks should have recovery plans as part of sound risk management. Supervision needs to assure that banks have such plans in place and that banks will in fact become resilient, even to extreme stress.

Resolution plans are more difficult. But they are an important form of contingency planning. They are the equivalent of civil defence for the financial system. This planning needs to be done, and banks should be in the position to provide the necessary information to permit the authorities to analyse the options for resolution, should resolution be required. Only through such planning can the authorities identify the steps that they will need to take and put themselves in a position to be able to take such steps if the need arises.

6 Postscript

At the Cannes Summit on 4 November 2011 the G-20 heads of state confirmed the conclusions of the Financial Stability Board regarding living wills. These require global SIFIs to develop living wills according to the framework outlined in this article. In addition, authorities are required to assess the resolvability of each global SIFI on a periodic basis. If a global SIFI is not resolvable (i.e. the resolution of the firm would either cause undue economic disruption or pose losses to taxpayers), the FSB recommends that authorities take steps as outlined above ('change the law' and/or 'change the firm') to make the global SIFI resolvable ('safe to fail'). For further details see Financial Stability Board, "Key Attributes of Effective Resolution Regimes for Financial Institutions," October 2011 (available at http://www.financialstabilityboard.org/publications/r_111104cc.pdf).

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Understanding a Living Will. Living wills and advance directives come into play only when one faces a life-threatening condition and is unable to communicate their desires for treatment. Doctors donâ€™t consult the wills for standard medical care that doesnâ€™t involve life-threatening situations. Every state provides for the drafting of a living will, although some states call the document a medical directive or a health-care proxy. A Living Will is a document used to describe how medical decisions should be made when certain health-related issues arise, especially when a person is dealing with a life-threatening condition. For example, should a person remain on life support if they have fallen into an irreversible vegetative state? That question can easily be answered by having a Living Will, as it will clearly state whether or not that person wishes to resume on life support in that situation. Living will defined and explained with examples. A legal document instructing physicians and relatives as to the individual's desires for end-of-life care.Â A living will is a legal document that gives written instructions regarding the makerâ€™s preferences for medical care in the event he or she is unable to express those desires. Many people find that planning ahead by making a living will helps ensure they get the type of care they desire, while removing the burden of making those choices from their loved ones. Living wills are also called active declarations. Such a document may be helpful to relatives and to medical professionals in the case of a seriously ill and incapacitated patient. Living wills are a part of planning what to do in the event of serious illness or disability. The phrase has been used as a handy media label to such an extent that many people focus on the document itself, rather than the actual process of advance care planning. It may well be that The living will document combines the Health Care Directive with a Medical Power of Attorney for when youâ€™re appointing an agent. But if you only plan to make use of the Medical Power of Attorney, then you donâ€™t have to include this part. Life Support. Often, people would create a living will template to make clear all of their preferences regarding life support. This is important, especially when you would become dependent on life support options to keep on living.