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Resolution and Recovery Planning: New Requirements and the Importance of Credible Challenge

By Emily D'Angelo and Michael Scarpa

The Federal Deposit Insurance Corporation (FDIC) approved a rule in June that updates large banks' requirements to plan for the possibility of insolvency and wind-down. The new rule requires insured depository institutions (IDIs) with assets of $100 billion or more (Group A filers) to submit more robust resolution plans than are currently required. And IDIs with assets of at least $50 billion but less than $100 billion (Group B filers) will have to submit informational filings, but not full resolution plans.

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Resolution and recovery plans are proactive strategies that aim to manage financial distress and ensure institutions can be recovered or wound down in a methodical manner. Regulators assess these plans for adequacy, effectiveness, plausibility, and preparedness for crisis.

The FDIC's updated requirements are aimed to increase the resilience of large banks, limit systemic vulnerability, and increase public confidence in the U.S. financial system. Additionally, modifications to the existing rule reflect lessons learned from recent bank failures in March 2023 and are focused on providing the FDIC with enhanced options to oversee bank resolutions successfully and at limited cost to the FDIC Deposit Insurance Fund and U.S. taxpayer.

Key to the FDIC's objectives will be the submission of a comprehensive "identified strategy" within resolution plans for liquidation and orderly, limited duration continuity of service until establishment of a bridge bank, acquisition by another bank or replacement in the event of failure. A default identified strategy, although not required, calls for an institution to position itself for a potential bridge bank scenario in case of failure.

Bridge banks allow for the temporary transfer of assets and liabilities to a new entity operated by the FDIC to support operational continuity and ensure customers can access accounts and services without interruption. The identified strategy must also include an exit strategy from the bridge bank, including the time required to execute it. Planning for a bridge bank scenario takes extensive preparation and considerable time given the complexity and size of the institutions involved.

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2023 Bank Failures and Recent Plan Shortcomings

The financial system has seen its fair share of bank failures and disruptions since the 2008 financial crisis. Most recently, the United States endured three of the largest bank failures in its history (three over $100 billion in assets): Signature Bank, Silicon Valley Bank (SVB), and First Republic Bank. These failures, primarily for Signature and SVB, were prompted by illiquidity due to withdrawals by uninsured depositors at record speeds and volumes. First Republic's downfall was largely triggered by contagion from the prior failures.

While Signature Bank had not yet submitted a resolution plan at time of its collapse, both First Republic and SVB had filed plans just a few months prior to their failures. However, the FDIC had not completely assessed or provided feedback on the plans. Nonetheless, had the resolution plans been sufficiently prepared or tested, the regulators likely wouldn't have had to make such quick decisions with potential adverse ramifications—many of which are still being felt today—given the aim of the plans to resolve operations with minimal cost to the FDIC and without significant disruption to the financial system.

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These episodes stress not only the importance of resolution planning, but the necessity to test the execution of such plans for adequacy and plausibility prior to a potential market shock or crisis.

Also notable are the significant costs that bank failures and their resulting mergers can impose on taxpayers, particularly through the mechanisms of government intervention and deposit insurance to stabilize the financial system. The Deposit Insurance Fund (DIF, a premium paid by banks) insures up to $250,000 per depositor, and bank failures cause the FDIC to use the DIF to cover insured deposits. Depletion of the DIF from significant losses leads to the need for taxpayer support.

Recent Plan Deficiencies

In light of the new and expanded requirements, it is critical for filers to evaluate past plan deficiencies for lessons learned and incorporation into the next round of plans, as applicable. The Federal Reserve and FDIC, upon review of resolution plans submitted in July 2023, found deficiencies in three out of four major U.S. banks' resolution plans. Weaknesses identified in the plans must be addressed when they are next submitted in July 2025. Deficiencies include:

- Inaccurate calculations of capital and liquidity needed to wind down, including updating certain economic conditions.
- Insufficient system capabilities to test stress scenarios and assumptions.
- Inability to accurately estimate resource needs outside of business-as-usual production hours for certain lines of business.
- Inadequate considerations of the timing, costs, and difficulty of winding down derivatives positions.

OCC's Proposed Amendments to Recovery Planning Guidelines

Support of enhanced resolution and recovery plans has also been stressed by both Fed Vice Chair for Supervision Mike Barr and Acting Comptroller of the Currency Michael Hsu while discussing resiliency in regulatory frameworks and the importance of recovery planning. Proposed revisions to the OCC's recovery planning guidelines align with the FDIC's final rule to enhance the resiliency of large banks. Revisions would expand the current threshold of banks with $250 billion in assets to cover banks with at least $100 billion in assets.

The OCC's proposed guidance highlights key elements to be included in bank recovery plans:

- Identification of credible triggers—both qualitative (credit rating shifts, occurrence of specific events, etc.) and quantitative (tied to specific metrics such as stock price, capital levels, etc.)—that reflect particular weaknesses.

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- Actionable options for restoring order such as identifying potential bidders, selling liquid assets, curtailing new business activity, and raising capital (including steps and timeframes required for actions to be taken).
- Impact assessments to recognize potential consequences on liquidity, operations, capital, and overall financial condition as well as impacts to various stakeholders from taking recovery actions.

Resolution Plans for FBOs

Foreign banking organizations (FBO) must adhere with U.S. banking laws and regulations, including liquidity and capital requirements, reporting obligations, and resolution planning requirements.

FBOs have seen heightened expectations regarding resolution planning requirements under 2020 rule revisions, addressing 2021 targeted plan submissions and 2024 full resolution plan submissions. Additionally, the agencies announced in 2022 additional guidance to assist these organizations with the development of upcoming submissions.

Guidance covers foreign-based triennial full filers (firms or specified firms), which are foreign-based Category II and III banking organizations.

- **Category II** (total global assets of at least $700 billion and cross-jurisdictional activity of $75 billion or more). Full resolution plans must be submitted every two years.
- **Category III** (total global assets of least $250 billion and total U.S. non-branch assets of $100 billion or more). Full resolution plans must be submitted every three years with targeted resolution plans required more frequently, focusing on material changes or updates.

General considerations for both categories:

- Interagency coordination between the U.S. and home country regulators.
- Detailed organizational structure, mapping of core business lines to material entities, and interconnectivity and interdependencies among material entities.
- Sufficient demonstration of capital and liquidity to support critical operations during resolution.
- Operational continuity including key payment and settlement systems and continuity of services provided by third parties.
- Legal entity alignment with critical operations and business lines.
- Strategies for managing derivatives portfolios during resolution.
- Robust MIS capabilities to provide timeline and accurate information.

Current guidance reflects experience with recent bank failures and the importance of cross-border coordination.

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46 banks qualify under the expanded rule.

Agency review of 2021 targeted resolution plan submissions by foreign-based triennial full filers subject to the 2020 FBO guidance revealed significant inconsistencies in the amount and type of information provided. Review also revealed opportunities for the quality and timeliness of the production of financial information as well as liquidity- and capital-related resolution capabilities necessary to support U.S. resolution strategies. Recent guidance reflects the agency's experience with recent bank failures and the intricacies that can arise with stress involving cross-border institutions and the importance of resolution planning and cross-border coordination.

Overview of Changes to the FDIC Rule

The FDIC first issued its Insured Depository Resolution Plan rule in 2012, requiring IDIs with over $50 billion in assets to submit resolution plans periodically, demonstrating effective resolution planning and ability to execute. The amended Insured Depository Institution (IDI) Resolution Planning Rule builds on the 2012 rule, incorporating lessons from prior resolutions of covered IDIs (CIDIs) to establish which information the FDIC needs to address failures.

The new rule separates institutions into two asset classes. Institutions with total assets of $100 billion or more would be considered "Group A" filers, required to submit full resolution plans, while institutions with total assets of at least $50 billion but less than $100 billion would be considered "Group B" filers, required to make an informational filing. Under the expanded rule, 31 IDIs would qualify as Group A CIDIs and 15 IDIs would qualify as Group B CIDIs.

The requirement to make a resolution submission—even in the form of an "informational filing"—is a significant new requirement for many Group B CIDIs, which is why planning and pre-work are crucial for successful compliance with the rule's expectations.

Group A filers will submit an identified strategy, from their potential failure point to the return of ownership to the private sector. The content requirements for informational filings for Group B CIDIs are similar to those for Group A CIDIs, except that Group B CIDIs would not be required to include an identified strategy, valuation approaches, or certain requirements under franchise components. The FDIC's assessment of informational filings made by Group B CIDIs will be similar to its assessment of resolution plan submissions made by Group A CIDIs.

Additional changes in the new rule also include content and timing requirements for resolution plan submissions. Most covered IDIs will be required to submit their respective resolution plans or informational filings every three years with more limited supplements submitted in between. The final rule also includes improvements in the approach to assessing the credibility of resolution submissions.

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The final rule will go into effect on October 1, 2024, with submissions due in the following year.

Preparing for Implementation

IDIs should be focused on:

- **Legal and regulatory compliance:** Identifying the additional requirements from existing plans to full plans and prioritizing the incremental work that needs to be done before and after the rule goes into effect.
- **Organizational structures:** Supplementing resources to identify and document organizational structure, legal entities, material entities, core business lines, franchise components, asset portfolios, critical services, key personnel, deposit activities, payment, clearing, settlement, economic effects of resolution, non-deposit claims, cross-border transactions, information systems, digital services/electronic platforms, communications, and governance.
- **Operational continuity:** Developing a strategy for continuity of critical operations, such as payment systems and trading operations, including an assessment of how actionable the strategy is pursuant to new OCC guidance on its viability and execution.
- **Counterparty risk and interdependencies:** Managing risks posed by relationships with counterparties, including other financial institutions, is a major challenge. In complying with the new rule's related provisions, banks stand to derive practical benefits in their business, as well.
- **Governance and oversight:** Establishing strong governance and oversight across all three lines of defense in the classic risk management model, specifically achieving first-line ownership of design and execution of the plans.
- **Actionable options for restoring order:** Delineating the object of sale, categorizing potential bidders, investigating legal and regulatory impediments, and preparing to populate a data room to enable buyer due diligence.

Testing Conformance to the Rule

The FDIC and other bank regulators have made expectations of assessment and testing of resolution capabilities clear in both formal rulemaking and verbal guidance. Prior to submitting plans, institutions should consider bringing in independent third parties to assist with:

- Credible challenge for identified strategies and failure scenarios.
- Drafting of executive summary/challenge of existing executive summaries.

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- Evaluation of assumptions and/or overall approach.
- Comprehensive review of impact assessments.
- Assessment of capital and liquidity calculations and related governance.
- Resource needs for bridge bank/wind down scenarios.
- System capabilities testing during resolution (core, payments, trading, etc.).

With the clock already ticking toward a deadline next year, the work begins now.

Conclusion

Large banks have their work cut out for them, as U.S. financial regulators release extensive requirements for new resolution and recovery plans. The coming year will be spent by financial institutions and their advisors in introspection, planning, and detailed reporting on how they'd contain future bank failures, should their worst-case scenario unfold. With the clock already ticking toward a deadline next year, the work begins now. For those banks that have been pulled into this rule or those facing expanded expectations, outside support from experienced professionals is critical. Don't go it alone.

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Navigating New Regulatory Waters: Key Changes and Challenges in Resolution and Recovery Planning

Tuesday, September 17, 2024
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- Risk Data Aggregation and Risk Reporting: Where Did It All Go Wrong?
- New Repo Reporting Rule: Get Ready for NCCBR Data Collection

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