Recovery and Resolution Planning: Some Practical Considerations

A joint discussion on the key elements of the RRP process and some of its more difficult challenges, by Promontory Financial Group, LLC and Sullivan & Cromwell LLP

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EXECUTIVE SUMMARY

Recovery and resolution plans — also referred to as RRPs or living wills — have emerged as a key supervisory tool in the aftermath of the global financial crisis. Global supervisors are determined to ensure that large, systemic financial institutions are “resolvable,” and RRPs are intended to serve as playbooks for rebalancing or ultimately dismantling institutions that find themselves under great stress. Many jurisdictions in the major economies that make up the Group of Twenty nations are in the process of establishing or implementing requirements for RRPs, and more are expected to follow suit due to the Financial Stability Board’s recent agreement for large systemic institutions to develop RRPs.1 This paper identifies the key elements of the RRP process, describes some of the more difficult challenges, and offers practical guidance based on our work with financial institutions facing these requirements.

Recovery plans and resolution plans are closely related but have different purposes. The two are based largely on the same information, but the recovery plan is institution-driven and focuses on steps that management would take to reduce risk and conserve capital in times of severe stress. The resolution plan is driven by the supervisory and/or resolution authority and takes over if and when recovery-plan steps prove inadequate. The purpose of the resolution plan is to identify and mitigate any obstacles to an orderly resolution and to define resolution options.

KEY ELEMENTS OF RECOVERY AND RESOLUTION PLANNING

Governance
The first step in planning the RRP is to establish clear governance for the project. The plan must be approved by the financial firm’s board, but day-to-day oversight will be in the hands of a senior executive supported by a steering committee. Governance must also be clarified for the ongoing maintenance and updating of the plan, and should be integrated with the firm’s existing governance and risk management structure. In addition, a governance structure must be clearly specified for managing the plan in a crisis, including triggers and identification of management officials who would invoke and execute the plan.

Information
Once governance is established, the firm must begin collecting information and identifying gaps in data and information systems. In collecting the information, the firm must identify its core businesses (those essential to the firm’s franchise value) and its critical activities (those with potential systemic impact), and map these to its legal entities.

Scenario Analysis and Stress Testing
The firm must next use the information developed on legal entities, core businesses, and critical activities to conduct a variety of analyses that set the stage for, and support the execution of, recovery and resolution options. The institution will have to identify its key vulnerabilities as well as

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its point of non-viability. Scenario analysis and stress testing must then be conducted for the recovery plan and resolution plan.

**Separability Analysis**

A financial institution is also expected to conduct a detailed analysis of the potential separability of legal entities. This is a focus of supervisors, and it is critical for both the recovery phase, where potential divestitures need to be identified, and the resolution phase, where options need to be developed for the continuation of systemically important activities and the sale or liquidation of others. There may be operational dependencies to deal with as well as financial linkages and support functions to consider.

**Recovery and Resolution Options**

Once the considerable information is assembled and the wide-ranging analyses are performed, the financial institution will have the base of information needed to develop recovery and resolution options. The recovery options will include a variety of actions to secure funding, raise or recover capital, and reduce risk. The actions will be drawn from the firm’s contingent funding and capital plans to a point, but the recovery plan needs to cover more severe financial distress than is typically reflected in contingent funding and capital plans. Not all jurisdictions expect financial institutions to develop resolution options, because the execution of resolution is in the hands of the authorities, but in all cases the firms are expected to provide the basis of information for such options.

**Management Commitments**

Supervisors will be looking for management to make any necessary commitments to make the plan credible, from remediating information systems to removing obstacles to resolvability. It is important to self-identify these needed actions and follow up on their execution.

**CHALLENGES**

There are a number of challenges for firms in the RRP process, including dealing with the scope and complexity of the project; determining the appropriate level of granularity and developing the data necessary to achieve it; having a line of sight over the systemic risk the particular firm poses to the system; and managing confidentiality concerns. Global firms face the additional challenge of complying with the potentially different substantive and timing requirements of various regulators, each of which is likely to have evolving expectations as experience is gained.

**Pulling It All Together**

Perhaps the most important challenge is to present the plan in a way that is credible and supported by clear and thoughtful analysis. A key part of the written plan will be a description and explanation of the corporate structure, including, among other things, the relationships among the core businesses, critical activities, and legal entities. A detailed and convincing rationale for this structure is crucial, particularly where a firm’s business lines do not align with its legal entities or geographic boundaries. Although supervisors understand the RRP process is new and daunting, they are under pressure to move forward expeditiously to completion, which means the regulatory stakes are high. Supervisors will be skeptical of future expansion if they are not comfortable with an institution’s current resolvability, as well as management’s commitment to maintaining that resolvability. It is incumbent upon the financial firms to demonstrate in their RRRPs and through their resulting commitments to regulators that their corporate structures — whether current or amended — can be taken apart and resolved, if necessary, in a manner that does not pose a risk to the stability of the financial system and the economy.

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INTRODUCTION

BACKGROUND

Global regulators have agreed to require large, complex financial institutions to prepare recovery and resolution plans (RRPs) as part of the regulators’ broader efforts to reduce the risk these institutions could present to the global financial system. The Financial Stability Board (FSB) — an international body, operating under the aegis of the G-20, that monitors and makes recommendations about the global financial system — recently issued guidance on RRPs, and many national regulators are in various stages of developing RRP requirements for their institutions. As a result, many large financial institutions are either in the process of, or beginning to consider, developing recovery and/or resolution plans.

The purpose of this paper is to highlight, based on our experience in working with a number of financial institutions, some of the practical considerations involved in developing RRPs. Though the RRP will be based in part on long-standing core institution processes, the RRP itself is entirely new, is extremely demanding, and requires significant time and resources.

The ultimate purpose of the RRP is to serve as a playbook for both management and supervisors in times of financial stress. The content should be actionable, current, and comprehensive. However, the significance of the RRP goes well beyond the utility of the plan itself. Developing and maintaining the RRP is likely to become a critical management process because of the strategic decisions that go into preparing it, the attention that needs to be paid to updating it, the other processes to which it must be linked, such as the contingency funding plan and the capital planning processes, the new data systems that need to be created and maintained, and the regulatory focus on it.

There is not one single correct approach to developing RRPs, largely because no two financial institutions are alike. Moreover, there are multiple regulators with different expectations, and the requirements are still evolving, and likely will continue to evolve as supervisors around the globe gain experience with the process. However, some essential elements are clear and unlikely to change, and it is not too soon to begin preparing. While regulators have indicated they will allow institutions some iterations to meet regulatory expectations, it is also the case that global supervisors are increasingly talking about resolvability as a key policy objective. Large, complex financial institutions that do not have RRPs that are convincing in the eyes of the regulators may find themselves with less strategic flexibility going forward. And, ultimately, institutions required to prepare RRPs could potentially face consequences ranging from higher capital requirements to required structural or operational changes and eventually forced divestiture, if their RRPs are not credible and well presented.

In this paper, we describe the steps involved in recovery and resolution planning, beginning with governance and including significant information collection and categorization, identifying vulnerabilities and conducting scenario analyses, assessing separability, and developing feasible recovery and resolution options. We discuss the elements that, in our experience, have presented the greatest challenges for financial institutions and offer some suggestions for maximizing the chances for regulatory acceptance of the plans.

KEY ELEMENTS OF RECOVERY AND RESOLUTION PLANNING

Recovery plans and resolution plans are closely related, are based on largely the same information, and will need to be updated in tandem. But from the regulator’s perspective, there are important differences. The recovery plan is expected to be financial institution-driven and an integral part of its planning and risk management activities. The resolution plan is oriented toward identifying obstacles to an orderly resolution upon the firm’s failure, so that it may address those obstacles, as well as providing information to the authorities for their use in preparing their own resolution plans, in coordination with other supervisors of the institution. Together, these plans will form an institution’s RRP.

Developing an RRP is a complicated endeavor, and not only because of the complexities of the large financial institutions that must prepare them. In developing the plan, a firm must conduct a variety of stress scenarios based on its own vulnerabilities, determine which scenarios bring into question its viability, and identify how it would respond as those scenarios play out — from business-as-usual, to increasing stress, and all the way through to resolution. The plan needs to include analysis that estimates the impact of the potential actions the institution would take under each scenario as well as the consequences to capital, funding and liquidity; to the various affected business lines, legal entities and material branches; and by jurisdiction. The plan must also incorporate strategies for the survival of businesses and functions that would threaten financial stability if disrupted, while enabling an orderly sale, shrinkage, or unwinding of other entities.

Furthermore, there are extensive information requirements associated with the RRP. Even if an institution has the capability to gather the required information, much of it will not conform to RRP criteria regarding format and organization. As a result, the RRP process will require lengthy file searches both to aggregate and disaggregate information. In addition, plans to automate

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1 See the FSB Report.

2 We use the term “supervisors” to encompass resolution authorities, even though in some countries resolution authorities are separate from supervisors.
ongoing data collection will be necessary both to maintain and update the plan, as well as for crisis management.

ESTABLISHING THE OVERALL RRP GOVERNANCE PROCESS

The RRP process is a major undertaking, requiring significant dedicated resources, particularly in the early stages of the process. Sound and well-understood governance is important for ensuring an effective and efficient approach. An institution should tailor the process governing the development of its RRP to its business profile. A senior executive, often from the risk or finance area, should take lead responsibility, ideally with the assistance of a steering committee, as the RRP exercise involves numerous areas of the institution. The effort should have strong participation from legal, compliance, and regulatory affairs departments, as well as support from technology and operations staff and business lines. The board should also have a defined role, including approving the RRP governance structure, receiving regular reports, and ultimately approving the plan submitted to regulators.

Institutions must integrate the RRP governance process with their current governance structures. It is particularly important to ensure coherence and linkages between the RRP exercise and contingency funding plans and the institution’s business-as-usual liquidity and capital planning strategy, internal capital adequacy assessment process (ICAAP), and business contingency plans.

Equally important is a well-specified governance structure for actually managing the institution in a financial crisis. The structure should include triggers that would lead to the explicit decision to be made whether to activate the plan, identification of key officials who would invoke and implement components of the plan, and a clear articulation of their roles and responsibilities, including any committees and crisis management structures that would be invoked, and a detailed communications plan covering regulators and all other relevant stakeholders. A credible plan also requires careful thought concerning the role of the CEO and the board of directors in a crisis.

Designing an Effective Challenge Function

Throughout the process, from initial project design to writing and submitting the plan, financial institutions should make use of a challenge function. A third party, whether internal or external, can be helpful at various stages in reviewing the work; challenging the reasoning; judging whether the conclusions are supported with adequate data and analysis; and questioning whether management commitments are sufficient and credible. Identifying and addressing gaps or apparent credibility issues in the RRP before a plan is presented to a regulator may be critical in avoiding the negative consequences that might arise if the regulator is the first to identify the gaps or issues. Financial institutions are obviously better off if they self-identify problems than if they wait and allow the regulators to identify them.

INFORMATION COLLECTION

Once the governance framework is established, the next step is for the financial institution to begin collecting information and identifying information gaps. The RRP is based on extensive information, much of which may not be readily available in the appropriate form at the outset of the process. In our experience, many firms will have difficulty aggregating information to achieve a coherent, enterprise-wide view. Those that have good enterprise-wide or business-line information may have difficulty disaggregating the necessary information into the granular, legal-entity view format that the regulators demand.

One of the major purposes of the RRP is to provide for the continuation of functions that, if discontinued, could pose a risk to the financial system and the economy. Thus, a key step in the collection of information is to determine which activities are core and critical.

- Core businesses are those that management considers essential to the franchise and intends to preserve through a crisis.
- Critical activities and functions — in some jurisdictions called systemic activities — are those that, if discontinued, could pose a risk to financial stability, as well as those functions that are considered necessary to support the firm’s important systemic activities.

Financial institutions also need to be able to map their business activities to specific legal entities — a challenge for many large, complex firms. Particularly important is the mapping between legal entities and the core businesses and critical functions. Financial and tax linkages must also be carefully considered and understood. In addition, human resources, technology, operational, risk management, contractual, and other interdependencies between legal entities need to be clearly delineated.

Identifying the Core Business Functions

Identifying core businesses is critical to recovery planning, because the surviving entity in a recovery plan must be a stable and coherent financial institution with continuing franchise value. Typically, businesses within a single financial institution are not simply core or non-core, but instead fall along a continuum. A financial institution

4 The nomenclature can vary across jurisdictions, but the concepts are widely used by supervisors.
may use a variety of quantitative and qualitative parameters to place businesses along this continuum. Results of this exercise will vary based on the business model and market position of the institution. The final ranking will require senior management judgment, as it is an important foundation for the RRP and should be aligned with business strategy and risk-taking. Furthermore, management will need to consider whether its perception of core businesses will likely change in a financial crisis, whether based on changes in the values ascribed to the quantifiable criteria used to identify core businesses in the plan, or based on additional management judgments and considerations that become evident during a crisis.

**Identifying the Critical Activities and Functions**

To determine critical activities that potentially pose risk to the financial system, management needs to consider not only those that reflect interconnections and dependencies between the institution and the financial system, but also the systemic importance of the institution’s role in key markets, including the substitutability of its products and services. Regulators will want the firm to consider the potentially disruptive impact on those markets and the broader economy if it withdrew abruptly. Indicators would include not just the firm’s market share, but also the challenges other firms would face in attempting to absorb its share.

Financial system interconnections and dependencies can be between the financial institution and other firms (e.g., correspondent banking); markets (e.g., as a primary dealer for servicing debt, as the dominant liquidity provider, or through membership in exchanges); and financial market infrastructures (e.g., payment, clearance and settlement systems or central counterparties). A thorough assessment of systemic risk involves investigation of all exposures that can arise through these connections, including an assessment of the degree of existing risk mitigation contained within certain markets and financial market infrastructures, size of flows, collateral triggers, etc. Of specific importance to the financial institution in a crisis are those activities that, if discontinued, can result in funding stoppages or reversals, both to the bank and to its counterparties.

Critical functions generally refer to intra-company interconnections and dependencies that support systemically important activities. These include the provision of critical business services, such as payments, technology, and operations across the institution; critical processes, such as finance and risk management; and the allocation of critical resources, such as capital, funding, human resources, and contractual arrangements.

While all aspects of the RRP are subject to supervisory review, supervisors often want to approve the definition and identification of critical activities before an institution gets too far down the road in its plan. Not only do they want firms to take a consistent approach, but there has been significant supervisory thinking and policy development on the subject of defining systemic interconnections between financial institutions. Moreover, supervisors have a better vantage point from which to evaluate systemic risk.

**Mapping the Legal Entities to Core and Critical Functions**

Identifying core and critical functions is challenging for large, complex financial institutions, but the challenge grows exponentially in the legal entity mapping process. Whereas a business line may operate seamlessly across geographic jurisdictions, it may do so through a network of legal entities tied to specific regulatory regimes and resolution or bankruptcy laws.

A major challenge in resolving a complex financial institution is untangling the corporate structure once the institution is no longer able to function as an operating group. In the RRP, a financial institution will be asked to map its legal entities to the business lines they support and to the economic functions those business lines provide — particularly in respect of the core businesses and critical and systemic activities. Many institutions preparing these plans could have thousands of legal entities. Developing a comprehensive view of these entities, their business purposes, the processes, resources and functions embedded in them, and the other legal entities they support will require substantial effort.

**Planning for Information Needed in a Financial Crisis**

It is in everyone’s interest that a recovery and/or resolution proceed quickly, if either has to occur. Indeed, some policymakers have referred to RRPs as rapid recovery and resolution plans. As a result, the RRP exercise includes a requirement for financial institutions to assess the systems and processes in place to be able to provide rapidly the kind of information that would be required by management, regulators, and, potentially, new owners in a crisis. The precise scope of this assessment is often unclear and varies from one country to the next, depending on other regulatory initiatives under way in the particular country to enhance financial crisis information. The fact that there is not yet a comprehensive cross-border agreement and understanding of what information is required in a crisis and, perhaps more important, how much resolution-related data should be collected by supervisors during normal, non-crisis times, causes further divergence among country-specific requirements.

The outcome of this exercise is typically metadata — information about the information that would be available during a crisis. This information would be along the lines of identifying the accountable manager; location; frequency; time lag required for aggregation and analysis; quality; and obstacles to effective use, such as key person dependencies or potential legal restrictions on information sharing. This metadata must provide an enterprise-wide view, functional views, and legal entity views of the accessibility of key financial crisis information. The self-assessment typically identifies gaps, and regulators will want to review the institution’s plans to address these gaps and to ensure that new processes are being put in place to collect and regularly update information requirements.

The information gathering described in this section is an extremely complicated but highly valuable endeavor. It provides the supervisors with needed information as well

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as assurance that additional information will be available during a crisis. It also forms the basis for a thorough management discussion and analysis of the financial institution’s preparedness for and ability to manage a severe financial crisis.

**Presenting and Justifying the Corporate Structure**

To set the context for the overall exercise, regulators expect the financial institution to provide a detailed overview of the corporate group. This overview should explain the organizational structure in a granular way, provide a rationale for that structure, and articulate the risks posed by the structure and by the firm’s business profile, and the way the risks are controlled. The corporate overview should also discuss the methodology and reasoning behind the identification of material entities, core businesses, and critical activities. Areas covered usually include:

- The number and nature of legal entities, and, importantly, the rationale for choosing to operate through branches vs. subsidiaries, and for making the related decisions about intra-group and financial support and business booking.
- The firm’s business lines and key geographic jurisdictions.
- Deposit-taking and other funding activities (including the maturity profile of wholesale-unsecured funding and the nature of its secured-funding practices).
- Risk appetite and profile, including key counterparties and an assessment of the impact of each major counterparty.
- Risk management practices and information systems that support those practices.
- Relevant liquidity and capital monitoring metrics.
- Trading and clearing systems to which the firm belongs and other systemic risk considerations.

The importance of this section of the RRP is that it provides the regulators with the business justification behind the organizational structure. The less an institution’s business lines align with its legal entities and/or geographic boundaries, the more likely it is that the resolution authority will question the structure. A detailed and sound rationale behind the structure is crucial.

**STRATEGIC ANALYSIS**

The next step in the process is to use the information developed on legal entities, core businesses, critical functions, and activities to conduct a variety of analyses that set the stage for, and support the execution of, recovery and resolution options. Analytical requirements may vary among regulatory jurisdictions, but typically include, at a minimum, the following components.

**Identifying the Key Vulnerabilities**

A financial institution will be expected to identify, describe, and quantify its key vulnerabilities — risks that can result in financial stress or cause difficulty in addressing financial stress should it arise. These vulnerabilities will be the starting point to generate scenarios for both the recovery plan and the resolution plan. These vulnerabilities may already be well-known to the institution and to its regulator, and figure prominently in its ICAAP and reverse stress-testing exercises.

**Agreeing on the Point of Non-Viability**

The financial institution will be expected to consider its point of non-viability. This is very challenging — and somewhat counterintuitive — because management’s natural focus is on operating the institution as a going concern.

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**Scenario Analysis and Stress Testing**

RRPs are typically driven by at least three scenarios based on the financial institution’s identified vulnerabilities and its definition of the point of non-viability — two for the recovery plan, and at least one for the resolution plan. The recovery plan includes one idiosyncratic and one systemic scenario, each of which is sufficiently severe to put the financial institution’s viability into question and to require a wider range of management actions than those usually deployed for liquidity contingency management. A key distinction for the purposes of the plan is that in an idiosyncratic scenario, management can assume that other financial institutions will generally be willing and able to buy
assets or operations when the institution is resolved.

For the resolution plan, whether the scenario is expected to be idiosyncratic or systemic — or a combination of both — varies by jurisdiction. To devise scenarios for the RRP, some regulators have suggested that institutions should use a reverse stress-testing approach and assume that it has not had an opportunity to implement extraordinary recovery actions as problems mount.

Based on the scenarios identified, the financial institution needs to employ stress testing to determine at a granular level the potential impact of distress on the institution as a whole and on its key components, as well as the feasibility and impact of potential recovery options. For example, the institution will be expected to:

- Develop a series of assumptions with regard to the run-off of funding liabilities, the draw-down of off-balance sheet commitments, and haircuts for asset sales, all of which reflect the financial institution’s circumstances, the severity of the crisis, and the time horizon over which the crisis is taking place. Where assumptions (such as the stability of funding sources) diverge substantially from those that are articulated as part of the emerging global regulatory regime for liquidity, the institution will be expected to justify this difference in terms of its asset-liability portfolio composition, circumstances of the scenario, or unique features of its key operating jurisdictions.
- For each scenario, analyze timed inflows and outflows of liquidity and impacts on the balance sheets, income statements, and regulatory ratios at both the enterprise level and for key legal entities and jurisdictions identified with respect to core businesses and critical activities.
- Conduct sensitivity analysis for key assumptions to demonstrate the degree to which the outcome is dependent on the assumption.
- For the recovery plan, show that the surviving entity has a viable franchise, is essentially profitable, and maintains sufficient capital and liquidity to operate.
- Depending on the requirements of the jurisdiction, show that resolution options will be effective without taxpayer support.

**CONDUCTING SEPARABILITY ANALYSIS**

One of the key issues on which regulators are focusing is separability analysis. The financial institution is expected to provide a thorough analysis of the potential separability of legal entities. This is critical for both the recovery phase, where potential divestitures need to be identified, and the resolution phase, where options need to be developed for the continuation of critical activities while liquidating others. In addition, financial institutions need to identify impediments to de-risking activities, such as the separability issues that would affect the time needed for sales of assets or businesses.

Separability analysis must consider many aspects of interdependency between legal entities within a firm and external relationships. First, there are intra-corporate operational relationships, including the technology, operations, legal, and human resources dependencies of the subsidiaries that might need to be spun off. Second, financial considerations include intra-corporate exposures such as derivatives transactions, booking practices more generally, guarantees, funding and capital support interdependencies, transfer pricing, tax issues, and the like. Third, there are corporate governance and risk management considerations, such as who would hold key management positions of a legal entity or branch that is to be run independently from the parent. The financial institution should also consider cross-border issues; for example, whether business lines operate across borders from the same legal entity and how easily they might be separated along jurisdiction lines. The interdependencies between entities that may need to be separated should be quantified.

**RECOVERY AND RESOLUTION OPTIONS**

Once this considerable information is assembled and the wide-ranging analyses are performed, the financial institution has the base of information needed to develop recovery and resolution options.

**Developing Recovery Options**

The financial institution should develop recovery options encompassing a variety of contingent funding and capital recovery actions to ensure that it can execute appropriate recovery actions while maintaining liquidity throughout the crisis horizon. Examples of contingent funding options include the sale of liquid securities or alternative secured and unsecured funding options. De-risking options may include the use of pricing to run down loan balances or divestiture of earning assets or businesses. Capital-preservation and capital-raising measures could include suspension or reduction of dividends, employee bonus pools, elimination/reduction of stock repurchase programs, and issuance of equity.

The overall menu of options and their prioritization should be based on findings from the separability analysis and be adapted to fit the circumstances of any specific crisis scenario. The considerations in determining recovery options are obviously considerable, including, but not limited to:

- Specific supervisory arrangements applicable to a firm’s various legal entities, such as prompt corrective action rules.
- Scenario assumptions regarding the changing economic and financial circumstances and their impact on franchise and market values.
- The impact of potential options on the institution’s business and risk profile, relative to its strategic plan and risk appetite.

In many circumstances, a financial institution’s core businesses are those that best maintain their value through a crisis. While the first choice is normally to sell non-core assets or businesses, it may be necessary to sell some of the core business assets (e.g., unencumbered liquid asset portfolios of capital markets businesses or credit card assets) in order to generate liquidity to offset crisis outflows.

In proposing its recovery options, the financial institution should consider the risks involved in their execution. These include not only the risks to successful execution in adverse market conditions, but also the
potential confidence and reputational risk to the firm’s going-concern franchise value associated with the execution of certain options (such as running down loan portfolios) vis-à-vis both customers and the investment community, including credit rating agencies and risks arising from negative announcement effects.

Analysis should include the timing of potential sales and the impact on the value of the company. Institutions should consider de-risking and divestiture options for both systemic and idiosyncratic scenarios, which will each present different valuation scenarios. They should also establish a process for ongoing review of various franchise and market values and link these to the action plans associated with the stress scenarios.

The question of when to implement the recovery options and their prioritization should be addressed, including developing decision-making principles, in order to choose among options when executing the recovery plan. One of the more difficult aspects is identifying the triggers for each action. Triggers should allow adequate time for recovery actions to succeed, be clearly defined, and be suitable for a variety of types of stresses.

Developing Resolution Options
Resolution options will be executed by the resolution authorities. Whether or not financial institutions are expected to develop resolution options varies by jurisdiction, but in any case, the institutions will be expected to provide the base of information for such options. The resolution options applicable to the financial institution’s legal entities will depend on the legal authorities and resolution regimes of the jurisdictions in which they are domiciled. These regimes vary considerably and are in flux in some jurisdictions.

While core businesses are those that a financial institution would want to preserve through a crisis, in resolution the perspective shifts to the value such businesses may have in the eyes of new owners — possibly public authorities for at least some of the institution’s assets. The policy objectives of the authorities in question are likely to include the protection of retail deposits, financial system stability, and avoiding costs to taxpayers. As a result, a financial institution’s retail franchise, if it has one, and any potentially critical activities are likely to be a focus of special interest in the resolution plan. For a custody bank or a financial institution largely focused on capital markets businesses, its critical activities will likely drive the planning process. For a trading institution with extensive involvement in clearing systems and other financial market “utilities,” the impact of its failure on those utilities will be a focus.

In considering resolution options, a financial institution will have to consider the dependencies identified during the separability analysis and how these will affect the regulator’s ability to move quickly to foster market confidence in the wake of the institution’s failure. The concept of “functional subsidiarization,” whereby highly integrated, centralized functions would be spun off into a separate legal entity that could be kept alive to provide services to group entities after they no longer function as a group, is gaining support among some regulators. The institution will need to consider the strategic implications of this potential solution.

MANAGEMENT COMMITMENTS
In the eyes of the regulators, a significant part of the value of the RRP is that the process itself will encourage financial institutions to make changes in their structures, business profiles, and processes that will lower the risk of failure and the likely cost of failure — that is, facilitate recovery and improve resolvability. Regulators expect management to identify significant ex ante measures that they intend to take to enhance their crisis and resolution preparedness and make commitments to take those actions within specified time frames. Examples of such measures could include intra-group service-level agreements to facilitate separability; legal entity simplification projects; improvements to capital and liquidity planning; and revision of information systems to enhance the availability of financial crisis management information. Regulators are more likely to find plans credible if action plans are included that self-identify any weaknesses or needed actions, with timelines given and responsible management named.

In limited cases where such measures do not satisfy regulators’ concerns about resolvability, institutions may be expected to restructure or divest certain businesses that impede resolvability. This is likely to be down the road after some iterations of the RRP but the potential is there, and the best way management can avoid such a step is to identify and address early on any resolvability concerns.

SUMMARY OF THE PROCESS
A high-level depiction of the RRP process is provided in the chart on page 10. This is intended to be a useful visual summary, but with one important caveat: developing the RRP is not a linear process. Although it begins with the establishment of a governance framework, each step from that point on is iterative and involves feedback among the components, and among the RRP components and other institution processes. In addition, there are processes that run parallel to the basic components, such as a challenge function, liaison with the regulators, and identification and implementation of management commitments. The plan will need to be updated at least annually and more often if there are material changes to the assumptions on which the plan is based, including changes to firm structure, operations, or risks. Finally, the process should be customized for each institution’s business model, mix of activities, and risk profile.

INTEGRATING THE RRP INTO ONGOING OPERATIONS
The RRP must dovetail with a financial institution’s risk management framework and other key business processes. Developing and maintaining the RRP will compel the financial institution to sharpen and closely link several existing processes. For example, the institution will need to augment stress

“The question of when to implement the recovery options and their prioritization should be addressed, including developing decision-making principles, in order to choose among options when executing the recovery plan.”

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testing programs already in place to include more severely adverse scenarios. The contingency funding plan will need to contemplate more extreme circumstances, with action steps appropriate for those circumstances. There will need to be feedback between the RRP and the ICAAP. Going forward, potential separability considerations will have to be incorporated into acquisition and expansion strategies. IT strategies and system improvements must take the RRP information needs and separability considerations into account. The business continuity and crisis communication plans must closely align with the RRP.

The RRP will play a different role at each financial institution and at each point in time, depending on the condition of a financial institution and its environment. As an institution moves along the continuum from business-as-usual, to increased stress, to crisis management, and potentially to wind-down, several aspects of maintaining and executing the plan will change. These include: the plan’s governance structure; the authorized decision-makers; the frequency and nature of risk assessment and reporting; the assumptions used in scenario analysis and stress testing; and the types of actions to be taken in carrying out the strategies outlined in the plan. In building the plan, a firm should be mindful of identifying key responsibilities for each phase, as well as clear links to other risk management processes, including the contingency funding plan, the ICAAP, and the stress-testing program.

**CHALLENGES**

Financial institutions encounter a variety of challenges in developing the initial version of their RRPs. Recovery and resolution planning is a complex undertaking involving contributions from across the central functions of the firm and key business lines, and requiring a perspective of the firm — the legal entity view — that most senior managers are not accustomed to taking.

**DEALING WITH THE SCOPE AND COMPLEXITY OF THE TASK**

As stated above, many financial institutions preparing RRPs will have hundreds or thousands of legal entities. Achieving the appropriate level of granularity for the RRP is a conceptual challenge that even the regulators issuing the requirement may have difficulty resolving. In many cases, some kind of risk-based or materiality principle is likely appropriate, but the teams creating these plans need to be cautious that, as a result of taking such an approach, they do not miss any key dependency or interconnection that could invalidate the thrust of the plans.

In addition to the challenge of finding the right level of granularity, the financial institution must consider: its operations across multiple geographic and regulatory jurisdictions and any inconsistencies that may exist in their (often still-evolving) resolution regimes for financial institutions, as discussed below; all the interconnections with other financial institutions, markets, or infrastructure; potential valuation of key elements of the business under a variety of highly stressed or resolution scenarios; and a range of information from insured deposit balances to where new owners could find the combinations to all the branch vaults. Financial institutions often have to work closely with their regulators to determine what simplifying assumptions are permissible in order to make the planning task tractable within reasonable regulatory deadlines.
**BRIDGING THE INFORMATION GAPS**

Financial institutions will encounter a variety of information gaps, some of which can be severe, especially with respect to the legal entity mapping requirement and the availability of specific kinds of information across all relevant legal entities and jurisdictions. If a proposed solution to a gap cannot be implemented in a timely fashion, it may require significant effort for the financial institution to achieve the level of granularity desired by its regulators. When mired in dealing with the data needs of developing the plan, however, it is not uncommon for institutions to lose sight of the fact that they also need to make the systems changes needed in order to be able to provide the information regulators expect in a crisis, which is typically more data, provided with significantly greater frequency. For this, system capabilities are essential, and regulators will expect to see the appropriate investment and project plans for needed improvements.

**MODELING INTERACTION WITH THE SYSTEM**

The RRP process will require financial institutions to conduct a self-assessment of the systemic risk they pose. The assessment will have two parts. First, institutions will need to determine the extent to which system infrastructure relies on their participation. System infrastructure includes payment systems, settlement systems, clearing houses, depositories, collateral registries, and other basic elements that support the financial system. Second, in order to determine potential knock-on effects, they will have to evaluate the extent to which clients, counterparties, and financial markets might be affected if they reduce services or fail to meet commitments.

The requirement to perform a systemic risk self-assessment from a single-firm vantage point raises practical and conceptual challenges. From a practical standpoint, individual firms have limited information about the other risk exposures of their counterparties, making it difficult to determine how seriously they will be affected. But more generally, systemic risk is dependent on the state of the financial system, which only a system-wide analysis can effectively determine. Individual firms may also know relatively little about where weaknesses in infrastructure may lie, making it almost impossible to assess whether a small disruption caused by the firm will have large repercussions for the system because of a breakdown of infrastructure. We have found that it is possible to bridge these gaps by following a methodology that combines detail on how the firm connects to the system with insight on where the system is vulnerable. In many cases, the firms have more insight than they may realize. The analysis can be further enhanced by communication with supervisors and others that have a broader view of current system vulnerabilities.

**MANAGING CONFIDENTIALITY CONCERNS**

A financial institution’s RRP will likely contain a large amount of highly sensitive information and analysis, from the designation of certain operations as non-core, to estimated valuations of businesses in severely stressed scenarios, to extensive detail about its liquidity management and funding activities. Much of this information and analysis would not normally be shared broadly even within the financial institution itself, let alone with competitors or with other market participants — particularly those that do not have the context to understand the highly contingent and low-probability nature of the RRP content. In many cases, the institution may not even be accustomed to sharing some of this information on a consolidated basis with all of its regulators. Certainly, advising a host-country regulator in advance that the financial institution would divest a subsidiary in a crisis could create lasting concerns, even if such an action is truly the best way to preserve the institution’s core franchise and the financial system overall. Recent regulatory leaks have only compounded this concern, as have legislative efforts to compel information from regulators.

If the RRP were a one-time exercise, it might be possible to control the flow of information and maintain some level of confidentiality among a core group of regulators. However, the annual update requirement attached to most RRP regimes means that the regular supervisory teams from all the financial institution’s regulators will be reviewing these documents on an ongoing basis and potentially sharing them with colleagues. In our experience, preserving confidentiality may be facilitated if sensitive information is kept separately for more limited presentation. However, it is not clear at this point that all supervisors have thoroughly considered or addressed the implications of these issues. Moreover, as the RRP exercise becomes better known and understood by various stakeholders, such as credit rating agencies, equity analysts, and fixed-income analysts, the markets may begin to force disclosure of key elements of the plans by the firms themselves, even if regulators do not do so.

**ADDITIONAL CHALLENGES FOR GLOBAL FIRMS**

Each of the issues discussed above becomes significantly more complicated for a firm with global operations. In most cases, these firms operate through a combination of branches and subsidiaries located in a wide range of jurisdictions. Usually, these branches and subsidiaries are subject to regulation and legal frameworks of both the country in which the parent or head office is located and of the country in which the branch or subsidiary is located. If a subsidiary’s parent is itself a regulated subsidiary of another entity, there may be multiple layers of such provisions affecting the operations of the subsidiary. This situation will add significant complexity to the RRP process.

In the first place, as RRP requirements proliferate across different home- and host-country regulatory jurisdictions, cross-border financial institutions will need to comply...
with all these various requirements. Ideally, these various requirements can be met through a single, coherent, enterprise-wide global RRP; however, the specific content requirements, the timing of the implementation of the RRP process, the method and format for reporting the required content, and the manner in which regulators will interact with or utilize the RRPs may differ from jurisdiction to jurisdiction. Large institutions will need to track these requirements — including jurisdiction-specific information requirements, such as the quarterly credit exposure report mandated in the U.S. regime — as these requirements evolve, and must integrate them into the overall RRP planning process.

In addition, analyzing and evaluating possible mechanisms for resolving global operations will be made more difficult by the restrictions imposed on institutions by the various jurisdictions in which the institutions operate. For example, the process of assembling the enterprise-wide data required by the RRP process may be constrained by data privacy and bank secrecy regulations, consumer regulations, and similar national requirements in individual jurisdictions within which components of the enterprise operate. At the same time, as noted above, a global financial institution may find itself faced with the prospect that information shared with one regulator in the course of responding to that regulator’s RRP requirements is shared with a regulator in another jurisdiction, without the opportunity to provide to that other regulator the context and rationale underlying the information — an event that could lead to challenges in ongoing relationships with those other regulators.

Furthermore, a financial firm with operations in multiple jurisdictions will be required to analyze and apply the national law of the various relevant jurisdictions in evaluating both the recovery and resolution elements of its plans. For example, in assessing the feasibility of an orderly resolution, an institution would be required to evaluate the insolvency and resolution legislation of each of those jurisdictions to its operations. This process will be complex, particularly because these regimes are evolving and, in many cases, conflict with one another. Institutions may be required to assess the impact of ring-fencing and similar mechanisms to the resolution of their multi-branch entities, and predict the manner in which national authorities would react and deal with each other in a crisis — something that is difficult for any party to predict.

**PULLING IT ALL TOGETHER: SUBMITTING A CREDIBLE PLAN**

Financial institutions should not underestimate the importance, and the challenge, of developing a well-written RRP that is supported by clear and thoughtful analyses and granular, enterprise-wide data. Virtually all the elements of the plan are subject to supervisory approval, including, to name just a few, the identification of core businesses and critical activities; the selection of scenarios for analysis; the assumptions behind the separability analysis; and the viability of the recovery and resolution options. Pulling together all the components into a written plan that will convince the regulators of the quality and comprehensiveness of the effort, and ultimately the resolvability of the institution, requires significant time and communication skills.

The final product will be a combination of descriptive material, information and data in tabular form, organization charts, flow charts, and similar documentation, submitted in loose-leaf form to facilitate modifying and updating. There may be separate chapters for various jurisdictions. Back-up policies, analyses, and other materials would likely be kept at the institution for further inspection by supervisors.

Each jurisdiction that requires RRPs will have a specific process for submitting the plan and receiving approval. This is a critical process, and both financial institutions and supervisors are feeling their way through it. To the extent allowed by local law, supervisors are likely to give firms some leeway to take an iterative approach while the firms develop the information needed and receive feedback from the regulators.

Nonetheless, the regulatory risk is high. Improving the resolvability of large complex financial institutions is high on the priority list of supervisors world wide. Moreover, there is developing international consensus that, ultimately, supervisors will use the RRP process as a supervisory tool to require financial institutions to remove or reduce any obstacles to resolvability. As with most matters that concern supervisors, financial institutions will fare better by undertaking a thorough and well-intentioned effort to self-identify changes that are needed in order to improve their resolvability. In addition, it is critical that firms engage in constructive, ongoing dialog with their supervisors and take seriously the feedback provided to avoid potentially harsh consequences.

One issue to which firms will need to be sensitive is the ambiguity over who “owns” the resolution plan. In some jurisdictions, for example the U.S., it is clear that the firms are required to develop certain resolution options. In others, for example the U.K., it is clear that the firms are not supposed to develop resolution options. In many jurisdictions, it is less clear. Two points are generally agreed to in any case: firms are expected to provide information to support resolution options, and supervisors and resolution authorities are responsible for executing any resolution actions. But beyond these two agreed concepts, there is a substantial gray area. In many jurisdictions, institutions will need to seek supervisory clarification to ensure that they understand the scope of their obligations as well as the degree of flexibility they have in designing their plans.

**CONCLUSION**

Developing and maintaining an RRP should be undertaken with the utmost seriousness. The RRP will become a key supervisory tool on which supervisors and resolution authorities will rely to ensure that the institution has a coordinated, enterprise-wide plan for managing through stress and also to ensure that it can be wound up, if need be, with minimum disruption to the economy. Done right, it can also have some business value by sharpening the strategic decision-making by management and the board, improving the information and analytical systems on which an institution bases many of its operations, and rationalizing organizational and legal entity structure. Firms that have the best outcome will be those that understand the RRP’s importance, devote adequate and appropriate resources to it, and keep open channels of communication with the regulators regarding it.

< See the FSB Report. | Sullivan & Cromwell LLP
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