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An Update on Preparing Living Wills for Foreign Banking Organizations—Exemptions and Important Strategy Considerations

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This analysis updates a previous memo and incorporates advice we have received from the Federal Reserve Board ("FRB") and the Federal Deposit Insurance Corporation ("FDIC") regarding the preparation of living wills by covered foreign banking organizations ("FBOs"), including an important exception for foreign banks only operating representative offices in the U.S., as well as a more limited exception for smaller FBOs in the U.S. (the "exempted covered company" exception).

In November 2011, the FRB and the FDIC adopted regulations requiring FBOs with global assets on a consolidated basis exceeding $50 billion and operating in the United States to provide a resolution plan for their operations in the U.S.

Because of the tier structuring based upon U.S. asset size, which determines when an FBO must submit its living will, the vast majority of covered foreign banks are required to submit their living wills on July 31, 2013 or December 31, 2013.

More importantly, the FBO community has become aware that numerous FBOs that have limited operations in the U.S. either may be completely exempt from the obligation of filing a living will, or else may be able to make use of a special, negotiated exception from the scope of a living will (provided that the FRB and/or the FDIC provide their approval of an application that must be submitted on or about the first week of April of 2013).

FBO Living Will Requirements

Living wills require extensive and detailed disclosure of the FBO's structure and operations, as well as the FBO's suggested approach for resolving the banking and non-banking assets under the federal Bankruptcy Code and the bank receivership provisions of the FDIC. In addition, for FBOs that are subject

to receivership/insolvency laws in other jurisdictions (including, of course, the FBO's home country), a discussion of the applicability of those laws is also required.

The FRB and the FDIC have learned from their initial review of the living wills submitted by the largest foreign and domestic banks that the exercise of preparing a living will is useful not because it provides a clear path to resolve an insolvent holding company or depository institution, but rather, because it provides both the U.S. regulators and the FBO a structured approach at the corporate level for resolving an insolvent institution based upon the legal structure rather than the cross-corporate operations of the enterprise as a whole.

Specifically, large, multinational financial companies operate based upon the implementation of business goals and not upon corporate structures and similar formalities. The "mapping" process envisioned by a living will permits both the U.S. regulators and the FBO to understand how the enterprise function can best be preserved by analyzing and determining how to preserve functionality across corporate members of the affiliated group that would be affected by the various insolvency regimes, should some or all of an FBO family fail.

As noted above, the FDIC and the FRB have recognized that the living will exercise is an iterative, ongoing process that will reoccur each year—with the intent that each year the level and quality of analysis will continually improve. (Of course, as the global financial system experiences or identifies new risks of loss, it is probable that at the time of each annual review of an FBO's living will the U.S. regulators may require a new or different analysis be employed to the previous year's living will.)

The result of the submissions of living wills for the largest banking organizations has resulted in two broad categories of analysis being addressed for bank and non-bank assets: The first is a recovery plan for FBOs that may be in danger of failing but may recover, such as by obtaining additional capital, selling of assets or lines of business, etc. The second category is a resolution plan, which presents a coherent organized pathway to liquidate an FBO (or corporate components of an FBO that has failed) and cannot continue to be operated except by utilizing the various applicable insolvency laws.

Categories of FBOs Covered by the Living Wills Requirements

FBOs with global assets in excess of $50 billion that operate a bank, branch, agency or commercial lender in the U.S. are covered by the living wills regulations. The very large FBOs with U.S. non-bank assets exceeding $250 billion have previously submitted their living wills. The dates that the two remaining categories of FBOs must prepare and submit living wills by are as follows:

- *FBOs with more than $100 billion of non-bank U.S. assets but less than $250 billion of non-bank U.S. assets—July 31, 2013.*
- *FBOs with global assets in excess of $50 billion but less than $100 billion of non-bank U.S. assets—December 31, 2013.*

There are two important exceptions available to FBOs from the obligation to prepare and update a living will—those exceptions are as follows:

Complete Exemption for FBO's Limited to Operating Representative Offices. The FRB and FDIC living wills regulations limit the applicability of complying with the living wills regulations to an FBO (and its parent) that: (a) operates a branch, agency or commercial lending subsidiary in the U.S.; (b) controls a bank in the U.S.; or (c) controls an Edge corporation acquired after March 1987. In other words, *if a foreign*

banking organization is limited to the operation of a representative office in the U.S., that category of FBO is exempted from the living wills requirements.

FBO Limited Exception—An "Eligible Covered Company." In addition to the exception for FBOs operating only a representative office in the U.S., the FDIC and the FRB have provided a limited exception that permits a qualified FBO (called an "eligible covered company") to file a streamlined living will, which is termed a "tailored living will." An FBO qualifies as an eligible covered company if it meets the following two tests:

- The FBO has less than $100 billion in non-bank U.S. assets; and
- The FBO's insured depository institution, branches and agencies comprise more than 85% of the FBO's consolidated U.S. assets.

If the FBO qualifies for this limited exception, instead of filing an extensive analysis that addresses in detail the recovery and resolution portions of the living will, it need only provide the introductory summary portions required for a living will, plus a limited strategic plan and interconnectivity and interdependency analysis, as well as regulatory supervision oversight information.

It is important to note two items should an FBO wish to qualify as an eligible covered company and hence make use of the limited exception discussed above.

First, the FBO must submit an application to the FRB and the FDIC no later than 270 days prior to the date the living will is required to be filed—which means that the application must be filed no later than the first week of April 2013.

Second, and more importantly, the FRB and FDIC staff with whom we have discussed this issue have emphasized that the granting of an exemption is entirely discretionary, and depends to a great degree on the clarity of the description of the FBO's operations as contained in the application for the exemption. This position appears to imply that the amount of detail contained in the application for the exemption that indicates the straightforward operation of the FBO is an important factor for the FDIC and the FRB to consider—which means that effort must be put into describing the FBO's operations in sufficient detail so as to qualify for the exemption.

Moreover, we strongly believe that advance consultation with the FRB and the FDIC regarding the content of an application for an exemption is critically important, lest an FBO file at the latest possible date and have its application rejected (whereupon it would be required to file a complete living will).

Content of FBO Living Wills for FBO Non-Bank Assets

As a useful perspective, the exercise of preparing a living will involves analyzing how the various bankruptcy and insolvency laws would impact an FBO, including its holding company and affiliated companies. Based upon the following, an FBO must analyze its resolution options and focus on the resolution of the FBO and its non-bank assets under the U.S. Bankruptcy Code:

- Executive Summary
- Strategic Analysis
- Corporate Governance Relating to Resolution Planning
- Organizational Structure

- Management and Information Systems
- Interconnectiveness and Interdependencies
- Supervisory and Regulatory Information
- Contact Information

In addition to addressing the possible application of the various U.S. insolvency laws, an FBO must also describe the applicability of international insolvency laws on the FBO's non-U.S. assets, including the bank resolution laws of the FBO's home country.

Further complicating the matter, the status of foreign branches and agencies in a liquidation mode requires a specialized analysis because, for example, under U.S. law a capital-deficient FBO may be required to pledge assets for obligations held on the books of an FBO within the U.S. In addition, even in the situation in which the financial records of an FBO's branch or agency do not present a concern, federal and state banking laws provide that state receivership laws might apply to the assets of a branch or agency of a foreign bank (in addition to or in place of the U.S. Bankruptcy Code and the Federal Deposit Insurance Act.)

Content of a Living Will for an FBO's Depository Institution

An FBO with an FDIC-insured depository institution with assets of $50 billion or more (referred to in the regulation as a "covered insured depository institution" or "CIDI") must submit a companion living will to the FDIC that contains the following components:

- Executive summary
- Organizational structure of legal entities, core business lines and branch system
- Critical services
- Interconnectiveness to the parent company's organization
- Strategy to separate the CIDI from the parent company's organization
- Strategy for the sale or disposition of the deposit franchise, business lines and assets
- Analysis of the least costly resolution method
- Asset valuation sales
- Identification of major counterparties
- Off-balance-sheet exposures
- Collateral pledged
- Trading activities, derivatives and hedging
- Unconsolidated balance sheet of the CIDI and other material entity financial statements
- Payment, clearing and settlement systems
- CIDI capital structure and funding sources
- Affiliate transactions, exposures and concentrations
- Systemically important functions
- Cross-border elements
- Management information systems

- Intellectual property
- Corporate governance and CIDI contacts

The requirements for submitting a living will for a U.S. bank subsidiary of an FBO should be virtually identical to the requirements of a bank owned by a U.S. bank holding company. However, the treatment of a branch or agency of an FBO may be more complex as compared to U.S.-based holding companies and their bank subsidiaries because of the existence or absence of FDIC insurance in regard to foreign branches and agencies.

FBO Living Will Compliance Approaches

In order to address the challenges of preparing a living will—whether or not an FBO believes it might qualify for a limited exemption—several steps should be considered as part of an overall project management approach.

First, the FBO should identify the functional unit that will be responsible for leading the project effort. In that regard, our experience to date is that the audit or risk management function is very frequently the choice. Financial reporting and information technology units should be included as critical team participants.

Second, the project team should engage in a mapping exercise that begins to address the various items identified above for the bank and non-bank assets, with particular emphasis not on enterprise-wide operations, but rather, on individual corporate separateness, ownership and control of the enterprise's operations and business functions.

Third, having completed an initial mapping exercise, at a very early stage in the process consultations should occur with the FRB and FDIC to elicit comments on the degrees of discussion and analysis that might be expected. At this juncture, experts on the various insolvency laws should become active participants in the project team (which may also include consultation with experts on U.S., international and home country receivership laws).

Fourth, if the FBO believes it can qualify for the limited exemption from preparing a complete living will, it should prepare its applications to the FRB and FDIC in sufficient time to be able to respond to inquiries, and to be able to proceed to the preparation of a complete living will should its application be rejected.

Finally, having completed the foregoing tasks, for those FBOs not qualifying for the limited exemption, the project team should proceed to the analysis of the recovery plan (including stress testing) and a resolution plan should the FBO fail.

Observations and Conclusions

Because the filing requirements for living wills for the remaining two categories of FBOs are now on the radar scope of many institutions, we offer the following observations:

Both the FDIC and the FRB have not yet completed their reviews of the first set of living wills that were submitted by the largest U.S. and international banking institutions in July of 2012. Although those agencies have indicated that they might eventually issue some general guidance to the remaining universe of U.S. and foreign banks that are subject to filing living wills over the next 13-month period, we have been told that FBOs should not anticipate any such guidance in the immediate future.

However, the FRB and the FDIC have emphasized that they would encourage individual meetings to be held by all covered entities, and would provide individualized guidance in focusing the efforts of FBOs to submit living wills that meet regulatory requirements.

At the end of the day, we note that the process should be viewed as a series of negotiations to translate the parameters of the living wills regulation to the corporate and asset structure of individual FBOs.

If you have questions, please contact the Pillsbury attorney with whom you regularly work, or the authors:

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