

R I S K

Resolution planning: How banks can tackle legal-entity rationalization in 2017

[Here's a primer on how banks can plot this year's work.](#)

Sarah Dahlgren, Merlina Manocaran, Gerhard Schröck, and Andrea Stefanucci

Eight years after the collapse of Lehman Brothers, armies of lawyers and accountants are still trying to unwind the bank's complex web of 2,985 legal entities and \$600 billion of interconnected portfolios scattered throughout 50 countries. Once bitten, twice shy: regulators around the world now require systemically important global banks to map out their structure of legal entities and business operations, understand the difficulties that would arise in resolution (for example, the risk that material entities will not have sufficient capital or liquidity to continue operations), and make a significant effort to simplify their legal-entity structure. Regulations differ by geography; Europe, the G20, and the United States have all established varying standards and regulations to address the problem of "too big to fail."¹ But the intent of legal-entity rationalization (LER) is everywhere the same:

to ensure that the corporate structure can be taken apart in resolution without radically disrupting financial markets.

After a rocky start, banks have made considerable progress on these requirements. For example, in the United States, seven of the eight largest bank holding companies passed muster by the end of 2016. But in 2017, to meet the rising regulatory standard, banks must double down on four essential components of LER: build a robust governance framework, simplify the LE structure and relationships, pave the way for transfer of liquidity and capital among LEs while also isolating risky activities, and adjust supporting operations in keeping with the structural changes.

LER is not straightforward. Even as banks make some things simpler, other complexities arise, such

as the need to ring-fence some entities and activities. For some institutions, various regulators' rules overlap, and banks are not always sure of putting their foot right. But some banks are finding a way through the complexities—not only complying fully but also deriving material benefits to the business. LER can fuel more efficient business activities as banks streamline and reorganize their operations, increase transparency, and reduce costs. Banks' fortunes have revived in certain respects, but another dose of efficiency will always be welcome in an environment of falling margins and increasing competition.

Much done, much more to do

In the United States, the Federal Deposit Insurance Corporation (FDIC) and the Federal Reserve have asked the eight largest domestic bank holding companies to conduct LER as a key component of resolution planning. While the focus is on the largest banks, the regulatory scope extends to the financial system as a whole. Targeted resolution plans are required for smaller bank holding companies and foreign bank organizations (FBOs) with global assets above \$50 billion.

In other geographies, such as Europe, where the regulatory authorities are developing resolution plans for individual banks, a similar outcome is likely. Banks whose complicated legal structures would be difficult to take apart in resolution will probably need to make significant structural changes to demonstrate that they can be easily separated.

Similar to the Comprehensive Capital Analysis and Review (CCAR) program that began in the United States in 2010 and reshaped the way banks view capital planning, resolution planning is driving banks to rethink their corporate structures and kick-start large-scale, transformative efforts such as legal-entity restructuring—actions that require significant attention from senior management and boards to review and approve. The largest bank

holding companies are redefining their business structures and operating models, from restructuring their ownership chains to reorganizing their supporting operations.

Yet getting LER right has been quite challenging. Many US bank holding companies struggled to obtain approval for their resolution plans. In April 2016, supervisors jointly identified deficiencies in the July 2015 plans of five banks. Banks resubmitted their plans in October 2016, and in December, regulators found that four of the five had closed their deficiencies. With that, seven of the eight banks are now focused on 2017, and specifically on the guidance provided by regulators.²

Banks have made considerable progress already—simplifying their legal-entity structures, eliminating thousands of legal entities, optimizing their geographical footprint, reducing the volume of intercompany transactions, realigning thousands of employees and other critical services, and simplifying the ownership structure of their legal entities. But not every bank is doing equally well. And they all need to keep going and show progress against the rising regulatory expectations.

In our experience, banks' achievements on LER have been hard won. Many are finding that the development of a fully credible approach remains a challenge. One difficulty is the need to integrate LER into the bank's governance structure so that business lines and legal entities can be aligned in a way that promotes resolvability. Banks must demonstrate that they can easily separate their legal entities without affecting critical services or intercompany transactions. Banks must also ensure that they can recapitalize key business units in a crisis.

While the 2017 guidance from regulators is far-ranging, the same four topics that have dominated recent efforts are likely to stay in focus (exhibit).

In the rest of this article, we will examine the challenges in these four areas and the practices that leading bank holding companies are using to overcome the challenges to arrive at a battle-tested, fit-for-purpose approach to LER.

Establish a robust governance framework

With so much accomplished, the last thing banks need now is for far-flung parts of their global enterprise to create more legal entities or to make choices that will complicate the resolution plans. Resolvability must be part and parcel of all business

decisions. And the LE structure must align with the business strategy. As the strategy evolves, so too should the LE structure. The LER work must include an approach to governance that keeps the structure firmly in control.

Before anything else, banks should create a clear, clean, well-maintained central repository of all key legal-entity information, updated in real time as new entities are created or eliminated. With that in hand, they can go on to establish a robust governance framework with the broad involvement of business

Exhibit

Banks have made significant progress on four essential activities.

Examples of major actions taken by leading banks

<p>Establish robust governance framework</p>	<ul style="list-style-type: none"> • Introduction of 20+ legal-entity (LE) rationalization criteria to support application of overall objectives • Establishment of senior-management committee to govern LE structure
<p>Simplify legal-entity (LE) structure and relationships</p>	<ul style="list-style-type: none"> • Reduction in number of legal entities by up to 65% • Reduction in branch network by 20% or more • Merger of 2 material entities in United States and planning for future elimination of material entities through merger and wind-down • Significant reduction and divestment of noncore activities • Reduction in intercompany derivative trades by 50% or more • Regrouping to put legal entities that would be sold together in resolution into the same intermediate holding company (IHC)
<p>Ease resource transfer across LEs</p>	<ul style="list-style-type: none"> • Elimination of 5+ IHCs that complicate capital transfer across entities • Establishment of new IHC that consolidates all material entities without 3rd-party debt to mitigate creditor challenge • Separation of institutional broker-dealer from retail activities
<p>Rationalize supporting operations</p>	<ul style="list-style-type: none"> • Transfer of 3,000+ employees and 5,000+ contracts from US broker-dealers into primary US material service entity • Transfer of primary service provider to a main banking entity

Source: Banks' public filings

and control functions. This process involves multiple steps, such as creating specific LER criteria that support the LER objectives and can be applied in a coherent way.

The criteria should be specific enough to be easily understood, and they should have a clear application to the legal-entity structure. For example, to support the objective of having as few entities as possible, banks may introduce a specific criterion to allow only one of each type of entity (for example, only one bank, one broker-dealer) in each jurisdiction.

Banks then need to write the criteria into their formal governance policies and procedures. Requests for exceptions should be reviewed periodically and challenged by senior management and subject-matter experts, to drive simplification. Some banks may find they need to either create new policies or enhance existing policies.

To establish robust governance, banks might consider an oversight committee to lead the LER effort. The committee should take an enterprise-wide view, to ensure that all LER initiatives are coherent and comprehensive, as well as to define the right balance across business and resolution priorities.

Simplify the structure and relationships

As banks expanded, they set up and acquired many LEs across multiple jurisdictions and did not always stop to assess the hidden costs of complexity. Now one, two, or more LEs may cover similar business activities in the same jurisdiction. Yet eliminating these redundancies is easier said than done; risks include loss of tax benefits, additional funding costs, and interruptions in liquidity flows. With considerable effort, several leading banks have already made great strides, reducing by thousands the number of legal entities in their organizations. But for ongoing success, banks must keep periodically reviewing existing legal entities for

additional simplifications. They must also evaluate closely the creation or acquisition of new legal entities, to validate the business need and assess the increase in complexity.

International branches and subsidiaries pose additional issues. As banks rethink their international footprint, they should define clearly the simplest and most rational legal-entity structure for each country, taking into account the business strategy and local regulatory requirements. This reassessment of the geographical footprint led one US bank to divest operations in more than 20 countries.

Simplifying the LE structure is critical, but it is not enough. Banks should also clearly assess how unraveling one unit might unintentionally affect others. Many banks have ensured that important entities have sufficient capital and liquidity. But the tangle of business and financial ties among them could impede resolution. For example, some banks have a book of intercompany derivative transactions worth trillions of dollars that is very complicated to unwind. To address this risk, banks are doing the hard work of mapping the full set of derivative trade relationships and limiting intercompany derivative trades whenever possible. This may require them to define a limited set of entities that transact with clients and, when possible, to manage market risk in these same entities, thereby limiting the need for intercompany transactions. In cases where intercompany trades are required, they should be performed in the same manner as third-party trades, to ensure they can be replaced in resolution.

Another effort to facilitate separation in resolution is the realignment of business lines and legal entities. This may lead to regrouping entities that engage in similar lines of business in the same legal-entity chain under a common holding company.

Ease resource transfer between entities while isolating business activities

The efficient transfer of capital and liquidity is often key to a successful resolution strategy. Complex ownership structures create frictions in the transfer of capital and liquidity across entities and from a holding company to subsidiaries. For example, the recapitalization of an entity by the parent will take many steps and need multiple regulatory approvals, board-of-director approvals, and solutions for other legal and jurisdictional issues. Such complex structures may bring a business benefit (reducing taxes, for instance), but supervisors are more concerned about resolvability than allowing banks to receive multimillion-dollar tax breaks.

To address these concerns, leading banks are reassessing the need for each intermediate holding company (IHC), by comparing the business benefits of each against its risks and costs. More often than not, this analysis leads to the elimination of IHCs. At the same time, some IHCs can be beneficial to resolution preparation. A few banks are actually introducing new IHCs to further support their resolution strategy and the recapitalization of material entities. Liquid assets can be pre-positioned in a new IHC and serve as a central buffer to provide additional support to material entities in resolution. The absence of third-party creditors for such an IHC is a clear benefit.

In some cases, the creation of an IHC is intended to address regulatory requirements. In the United States, FBOs with global assets above \$50 billion are required to establish an IHC and position under it all the US operations, with the exclusion of branch offices. In November 2016, the European Commission published a legislative proposal with similar requirements for large non-EU banks. This change is intended to ensure that the EU operations of foreign banks are sufficiently capitalized and

funded so that if the group fails, there is enough capital and liquidity locally to absorb the losses of the group's European operations.

As banks develop their capital and liquidity models, they should consider how the legal-entity structure affects the allocation and transfer of these scarce resources. Elimination of entities or the simplification of the ownership structure can facilitate the transfer of resources. Closely aligning the recapitalization strategy with the LER approach can help both efforts. First, it can help banks address supervisory concerns about the feasibility of the resolution strategy, by simplifying the recapitalization path. Second, it may reduce the resources that need to be pre-positioned in each entity.

While paving the way for efficient resource transfer, banks should also ensure that risky global-markets activities—with a potential of contagion in a crisis—are isolated from retail deposits or retail activities. As part of their resolution planning, banks should both reassess the activities booked in each entity and also map and optimize the risk transfer between entities in the same ownership chain. Several banks have already begun to build and use different legal-entity chains for institutional and retail activities.

Rationalize supporting operations

Operating a network of LEs requires support such as staff, technology, and physical assets; and intangible assets such as intellectual property and access to financial-market utilities (FMUs). Rationalizing these services is the fourth key component of successful LER.

To ensure the continuity of critical services in resolution, banks should review the full networks of critical services and, when possible, relocate them to a small number of well-capitalized and well-funded service providers. These organizations can provide

critical services in the period of stabilization during the orderly execution of the preferred resolution strategy, so they are required to maintain six months of working capital.³

To support transparency and separability of supporting operations, banks should also enforce service contracts, at arm's length to the extent possible, through the use of service-level agreements. SLAs will allow for continuity of services to entities that are sold in resolution, by allowing them either to keep receiving services from the same operating company or to replace it with an external alternative provider under a contract with similar terms.



Apart from keeping the bank in compliance with regulatory requirements and meeting supervisory expectations, the work we have described here can offer genuine business benefits:

- Robust governance of the legal-entity structure allows banks to think proactively about how best to align their legal-entity structure with their business strategy and eliminate components that are irrelevant as the business strategy evolves.
- Simplifying and rationalizing relationships among entities helps banks establish discrete business operations that, when necessary, can easily be divested. For many, it will also yield cost savings and increased transparency. A leading US bank reported that its simplification work yielded a 15 percent increase in productivity.
- Segregating business activities in purpose-built entities will create discrete business lines with significantly different risk profiles, which can be managed more efficiently than if the activities were commingled.

- A rationalized support structure creates full transparency of intercompany operational relationships, volumes, and costs, thus making possible better business decisions.

With a solid foundation underneath them, banks will find that 2017 is the year when they can take decisive steps on LER and see the business benefits drop to the bottom line. ■

¹ The G20 endorsed the Key Attributes of Effective Resolution Regimes of the Financial Stability Board (FSB) in 2011. This international reference document requires member jurisdictions to establish frameworks for the orderly wind-down of large, systemically important financial institutions. As a result, in Europe, the Bank Recovery and Resolution Directive (BRRD), among other rules, established cross-border resolution mechanisms in 2014. In the United States, Section 165(d) of the 2011 Dodd-Frank Act sets out resolution-planning requirements.

² FDIC and Federal Reserve, *Guidance for 2017 §165(d) annual resolution plan submissions by domestic Covered Companies that submitted resolution plans in July 2015*, federalreserve.gov.

³ Ibid.

Sarah Dahlgren and **Merlina Manocaran** are partners in McKinsey's New York office, where **Andrea Stefanucci** is a consultant; **Gerhard Schröck** is a partner in the Frankfurt office.

The authors wish to thank Gabriela Skouloudi and Alexis Trittipò for their contributions to this article.

Copyright © 2017 McKinsey & Company.
All rights reserved.