Contingency Planning & Simulation Exercises: Practical Applications

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Thinking About Simulation Exercises

- **What is the objective of the exercise?**
  - What do you want to accomplish – test procedures, explore alternatives, test decision-making?
- **What are the key issues to include?**
  - Within the objective, what questions must be answered?
- **What will be the next steps?**
  - How will the exercise facilitate improved preparations or contingency planning?
- **What scenario/situation will best achieve the objective?**
  - how should the exercise be structured to achieve the objective?
Goals of FDIC Simulation Exercises

Simulation Exercises Reflect FDIC’s Roles in U.S. Financial System:

FDIC’s Roles:
• Deposit Insurer
• Back-up Supervisor for all Insured Banks
• Receiver / Conservator for Failed Banks

In Bank Resolutions, FDIC Has 3 Major Goals:
• Minimize losses to the Deposit Insurance Fund – “Least Cost”
• Protect Insured Depositors & Maximize Recoveries for Creditors
• Reduce legal & financial uncertainty
Overview of the Resolution Process

These goals must be met within a specific legal/policy/industry infrastructure:

- Increasingly concentrated banking industry – large banks are national, global, and complex
- Prompt Corrective Action – “trigger” for intervention and, ultimately resolution
- Reimburse insured depositors as soon as possible – typically by next business day
- Minimize costs to Deposit Insurance Fund
- FDIC has power to act immediately to operate failed bank and sell assets – this includes bridge bank power
- Strong legal authority to terminate or enforce contracts, avoid transfers, and design flexible resolution and sales structures
- Emphasis on market solutions – quick return of assets to private sector
Key Design Issues – Framing the Exercise

• Who are the key participants in a large bank resolution? What are their roles and responsibilities?

• What are FDIC’s plans and procedures for managing a large and complex bank failure? What changes need to be made to more successfully manage a failure?

• What are the processes and challenges associated with least-cost decision-making?

• What are the critical operational challenges (i.e. deposit insurance claims, derivatives, settlement, communication, timing, etc.)? What the key pressure points?

• How well do current monitoring and resolution plans adequately address large bank risks? How can be they improved?
Previous Large Bank Failure Simulations
Summary of Selected Simulations: Simulations tested increasingly complex scenarios

<table>
<thead>
<tr>
<th>Simulation</th>
<th>Date</th>
<th>Total Bank Deposits (in Billions)</th>
<th>Key Simulation Characteristics</th>
</tr>
</thead>
<tbody>
<tr>
<td>Alpha</td>
<td>Sept. 2002</td>
<td>$43</td>
<td>Planning exercise to help prepare for the failure of a large regional bank without systemic implications</td>
</tr>
<tr>
<td>Gamma</td>
<td>Dec. 2004</td>
<td>$21</td>
<td>Simulated the operations of a bridge bank</td>
</tr>
<tr>
<td>Delta</td>
<td>Dec. 2005</td>
<td>$5</td>
<td>Simulated a deposit insurance determination of a commercial bank, tested RPC-approved claims shortcuts</td>
</tr>
<tr>
<td>Intero</td>
<td>Dec. 2006</td>
<td>$24</td>
<td>Simulated planning for a large regional commercial bank</td>
</tr>
<tr>
<td>Strategic Simulation</td>
<td>May 2007</td>
<td>Stress on Multiple Banks within Large Bank Holding Companies</td>
<td>Simulate and stress strategic decision-making and planning processes in pre-failure and post-failure scenario</td>
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</table>
Lessons Learned

- Access to the bank prior to failure is critical for a successful resolution. Thorough understanding of data systems and business processes, and identification of key personnel are essential.
- Identified difficulties in developing loss estimates for a large institution.
- Determination of deposit claims more difficult – process improvements required for large institution.
- Derivatives operations require additional, timely information – process improvements needed.
- The threat of ring fencing complicates the transaction structure and diminishes franchise value.

Situation Presented

- Large regional bank, not systemic
- Offices in three foreign countries
- 30 days to plan closure
- $50 billion derivatives portfolio

Process Tested

- Strategic planning tools
- The resolution strategy for a multi-billion dollar commercial bank that does not pose a systemic threat, including resolution structure, claims process, and capital markets activities.

Alpha simulation alerted the FDIC to its need for faster processing for returned items after a bridge is in place.
## Intero explored a combination of key operational and policy questions

<table>
<thead>
<tr>
<th>Situation Presented</th>
<th>Process Tested</th>
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</thead>
<tbody>
<tr>
<td>Little lead time on the failure</td>
<td>Capital Markets Instruments</td>
</tr>
<tr>
<td>Liquidity crisis</td>
<td>Sweeps arrangements</td>
</tr>
<tr>
<td>Negative media</td>
<td>Bridge bank funding</td>
</tr>
<tr>
<td>Drop in commercial real estate values and major credit losses</td>
<td>Advance dividends and claims impediments</td>
</tr>
<tr>
<td></td>
<td>Affiliate interconnections</td>
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</tbody>
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### Lessons Learned

- The exercise suggested that certain legal powers could serve as leverage with the holding company in negotiating for critical affiliate services for the bridge bank.
- Advance preparation and periodic review of time sensitive data needs and business line analyses essential. Enhancements in risk focused analytics should be pursued to improve readiness.
- Increasing staff cross-training and interdepartmental training necessary.
2007 Strategic Simulation focused on strategic decision-making during crisis management

**Situation Presented**
- Significant deterioration in U.S. economy
- Three large banking companies experience instability
- One institution very likely to fail with two others potentially tied to its fate

**Process Tested**
- Strategic decision-making for management of pending failure
- Current planning processes for large bank failures across disciplines

**Lessons Learned**
- Close coordination with other regulators and advance access to information about bank’s interrelationships with affiliates and third parties is crucial.
- Key steps in deposit claims process directly influence flexibility in implementing a bridge bank resolution. Accordingly, further steps should be taken to complete regulatory process for enhanced claims procedures.
- The decisions taken in implementing the bridge bank resolution, such as advance dividends and funding, will affect its effectiveness in achieving maximum franchise value and stability.
Past Exercises Highlighted Necessary Improvements and Allowed Focus on Increasingly More Complex Scenarios

• FDIC simulation exercises have been designed within the context of specific provisions of U.S. law and policy for bank resolutions

• Exercises first focused on testing specific processes to be used if a large, complex bank fails

• Subsequent exercises have built on past exercises to combine processes necessary to address increasingly complex institutions and, thereby, enhance readiness

Thank you!