A Commitment to Financial Stability

PHOTO: MICHAEL BATTS

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More than six years after the financial crisis of 2007–08, policymakers, regulators, and researchers are still wrestling with how best to prevent a similar crisis in the future. The primary legislative response was the Dodd-Frank Act of 2010, which contains a number of constraints on risk-taking by financial institutions, such as stronger capital and liquidity requirements and periodic stress-testing. Such constraints are important, but, as Arantxa Jarque and David A. Price explore in this year's essay, they do not solve the fundamental problem of institutions that are perceived as "too big to fail." Instead, we must find a way to make regulators and policymakers commit in advance to not provide rescues—expensive, taxpayer-funded rescues—to firms in times of distress. Such commitment is essential for reducing moral hazard and realigning the incentives of financial market participants. The Dodd-Frank Act created an effective tool to achieve this goal: resolution plans, or "living wills."

A living will is a detailed plan that explains how a financial institution could be wound down under the U.S. Bankruptcy Code without threatening the rest of the financial system or requiring government assistance. Under the Dodd-Frank Act, large banks and other systemically important firms are required to submit these plans on an annual basis for review by the Fed and the Federal Deposit Insurance Corporation (FDIC).

How can living wills help solve the "too big to fail" problem? As Jarque and Price explain, the problem stems from a series of rescues and other interventions by the Fed and the FDIC dating back to the 1970s. These interventions created widespread expectations of government support if a large financial institution were to become troubled. These expectations dampened incentives to contain risk-taking, thus encouraging higher leverage and more reliance on short-term funding. Over time, this cycle of rescue and failure has made our financial markets more fragile.

Living wills can help put an end to this cycle by making bankruptcy a viable alternative to bailouts for large financial firms. Bankruptcy is preferable to our current ad hoc system of rescues for a number of reasons. First, bankruptcy, with clearly defined rules and safeguards for the treatment of creditors, can provide more consistent and predictable outcomes. In addition, a bankruptcy proceeding can help prevent individual creditors from pursuing individual remedies—that is, from starting a "run" that would destroy the firm's value. Finally, in modern economies we generally presume that competitive forces drive parties toward financial arrangements that are relatively efficient, given the rules of the system they face. The bankruptcy system reinforces this beneficial feature of competitive markets, since the deadweight costs are borne exclusively by the firm's creditors and other stakeholders. The result is a collective interest, ex ante, in avoiding behaviors that would make the firm excessively vulnerable to financial distress.

Certainly, as Jarque and Price note, there are challenges to resolving a large financial firm through the bankruptcy code. One challenge could be the substantial liquidity needs of large financial firms. Other types of firms generally rely on a type of short-term financing known as "debtor-in-possession" (DIP) financing to see them through a bankruptcy proceeding. But for a variety of reasons, lenders might be unable or unwilling to meet the DIP financing needs of a large financial firm.

Another challenge is the complexity of our largest financial institutions, some of which have thousands of subsidiaries. If such a firm becomes distressed, regulators might want to separate the parts of the institution that perform "critical functions" for the rest of the market and arrange for them to be taken over by another institution. The more subsidiaries there are, the more difficult it may be to tease apart their relationships. In addition, bankruptcy courts could be constrained by the existence of vital shared services that are operated by one subsidiary but relied on by others.

Living wills can actually help us address these challenges. That's because when regulators review the living wills, they don't have to take the firms' current size and structure as given. If the Fed and the FDIC jointly determine that a plan would not credibly resolve a firm through bankruptcy, the firm must submit a revised plan. If the revised plan still isn't credible, regulators can require more capital, increase liquidity requirements, or restrict the growth, activities, or operations of the firm. They can even require firms to make divestitures.

The Dodd-Frank Act created another method of resolving large financial firms, the Orderly Liquidation Authority, or OLA. The OLA gives the FDIC the ability, with the agreement of other financial regulators, to take a firm into receivership. The FDIC also has access to a line of credit from the U.S. Treasury to make payments to creditors or to guarantee the liabilities of the failed firm.

While the OLA is intended to supplant bailouts, it retains many of the critical flaws of pre-crisis practices. For example, the Act gives the FDIC the discretion to pay some creditors more than they would obtain in bankruptcy. This creates additional uncertainty for creditors about their returns and potentially allows funds to be channeled to favored creditor classes. In addition, the ability of the FDIC to inject Treasury funds means that market participants will likely expect at least some creditors to be protected from losses, thus perpetuating the dynamic we saw play out before and during the crisis.

Resolution planning for large, complex financial firms is difficult, painstaking work. But living wills are the most effective path toward restoring market discipline and dismantling the expectations that have created "too big to fail." As Jarque and Price's thoughtful analysis demonstrates, the potential costs of living wills are far outweighed by the benefits to us all of fostering a stable and resilient financial system.

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