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Living Wills for Systemically Important Financial Institutions: Some Expected Benefits and Challenges

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The Dodd-Frank Act requires systemically important financial institutions to create resolution plans, or "living wills," that bankruptcy courts can follow if these institutions fall into severe financial distress. The plans must set out a path for resolution without public bailouts and with minimal disruption to the financial system. While living wills can, in this way, help to curb the "too big to fail" problem, regulators face a number of challenges in achieving this goal. The authority granted to regulators by the Act, including the power to make systemically important institutions change their structures, offers promising means of addressing these challenges.

When Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act in 2010, the elimination of bailouts for distressed financial institutions was among its goals. One of the Act's measures in this regard was the creation of a new tool—known as resolution plans, or "living wills"—aimed at giving regulators an enhanced understanding of, and increased authority over, the largest and most complex financial institutions. In particular, living wills and their associated regulatory provisions are intended to make these institutions, known as systemically important financial institutions (SIFIs), resolvable without public support if they become financially distressed.

The need to make SIFIs resolvable without public support has its conceptual basis in the idea of commitment. Research has indicated that policymakers can reduce instability in the financial system by making a credible commitment not to rescue failing institutions, thereby inducing the creditors of these institutions to monitor and influence the institution's risk-taking to a greater degree.[1] But given the uncertainty about the costs to the financial system of letting a SIFI fail outright, it is more difficult for policymakers to make such a commitment without a roadmap for winding down a SIFI in an orderly manner if it becomes distressed—that is, a living will.

In practical terms, the provisions of Dodd-Frank on living wills require these firms to produce resolution plans to be followed in the event of severe financial distress. On an annual basis, all SIFIs must submit detailed plans to the Federal Reserve and the Federal Deposit Insurance Corporation (FDIC). With some work back and forth between a SIFI and the agencies, a plan ideally becomes a source of information about the potential consequences of the firm's failure and how to minimize them—although this information will necessarily be subject, in practice, to considerable uncertainty.

If the Fed and the FDIC find that the best feasible plan does not set out a credible path to resolving the firm without public support, they have the power to require the firm to increase its capital or liquidity, limit its growth, activities, or operations, and even divest assets to make such resolution a credible option in the future. This scenario is likely, given the potential need of distressed SIFIs for large amounts of short-term financing, the organizational complexity of SIFIs, and cross-border issues involved in winding down a SIFI. Evaluating the need for such changes, as well as the appropriate level of transparency for living wills, is no simple task. This *Economic Brief* considers these challenges confronted by regulators who must oversee the transition of SIFIs to resolvability, and some possible approaches to managing them.[2]

Short-Term Financing

One of the challenges facing policymakers is that SIFIs in their present form have large liquidity needs. In the event of distress, finding interim funding may be important to minimize losses and market disruption. Hence, regulators assessing a living will should consider who could realistically provide this funding.

When firms other than SIFIs are in bankruptcy, they meet their short-term financing needs through "debtor-in-possession," or DIP, financing. This type of financing, which must be approved by the bankruptcy court, is generally senior to the firm's already-existing debt. The firm's creditors nonetheless are commonly willing to approve DIP financing because it keeps the firm in operation. DIP financing often comes from private equity firms, hedge funds, large banks, or existing creditors.

SIFIs, however, may face particular difficulties by virtue of the large amount of DIP funding they are likely to need and because their bankruptcies may arise during a period of broader problems in financial markets. By definition, SIFIs tend to be very large firms and tend to have high short-term liquidity needs to the extent that their business models are based on maturity mismatch (for example, accepting deposits that can be withdrawn on demand and using them to fund long-term loans).

The question is, would a failing SIFI, given the financing needs that its size and structure imply, be able to obtain sufficient DIP financing to see it through the bankruptcy process? Would it still be possible if the distress occurred during a time of market crisis, when providers of DIP financing may be more cautious or in distress themselves? If not, authorities may feel compelled to provide emergency financing, effectively providing a bailout and encouraging moral hazard.

To maintain a credible commitment not to provide financing—that is, not to rescue the firm—policymakers may therefore need to limit the reliance of some SIFIs on maturity mismatch. The combination of very large institutional size and heavy reliance on maturity mismatch should not be assumed to be essential to financial markets. When reviewing living wills, regulators may determine that if a SIFI wishes to retain its large scale, it will need to reduce its reliance on short-term liabilities. Alternatively, if the firm believes that the costs of reducing its maturity transformation would be unacceptable, it could instead make itself smaller by shutting down certain business lines or, more likely, spinning them off. Ease of resolution should play, together with safety and soundness considerations, a critical role in determining what constitutes acceptable practice in financial intermediation. In contrast with safety and soundness regulations, which may limit short-term financing with the objective of preventing the failure of a financial institution, the living wills process addresses the expected need for DIP financing once the failure has happened.

Once policymakers have established a credible commitment not to rescue firms in distress, the lack of a safety net would cause the price of debt to become more sensitive to the amount of maturity transformation, leading SIFIs to restrain their reliance on short-term funding and reducing the need for DIP financing.

Organizational Complexity

Another potential obstacle to making institutions resolvable is that they may have highly complex structures. One simple measure of this complexity is the sheer number of entities within today's institutions: In 2012, six U.S. bank holding companies had more than 1,000 subsidiaries, up from only one such firm in 1991. Four of those six had more than 2,000 subsidiaries.[3] The rise in complexity has come from a number of circumstances creating economies of scope and scale in the industry, making growth in firm size and diversification attractive. A few of these are technological scale economies, expansion across state lines and globalization, and the rise of asset securitization, among others.

One reason why complexity may be a hurdle to unassisted resolution is that regulators might want to separate the parts of the institution that are most important to the stability of the overall financial system (those that perform clearing and settlement services, for example) and arrange for those to be taken over by another institution. The larger the number of subsidiaries, the more challenging it may be to untangle their relationships and determine which ones perform critical functions. In addition, when bankruptcy courts resolve a large, complex institution, their options may be constrained to some degree by the existence of critical shared services—for example, information systems that are run by one entity but relied on by other entities within the firm.

As with the challenge of short-term funding, to the extent that regulators believe complexity may stand in the way of unassisted resolution, the Dodd-Frank Act gives them the power to require SIFIs to reduce their complexity. They might, for example, direct the firm to spin off lines of business, consolidate subsidiaries, or duplicate certain functions to make some entities more self-sufficient. Regulators concerned with efficiency should seek to strike the right balance, as changes of this nature will involve adjustment costs and perhaps forgoing economies of scope and scale. (A different case would be one where complexity has been driven by the pursuit of tax advantages; in this case, the increased tax burden that may result from undoing that complexity should not be a concern to financial regulators.)

Market forces should also prove helpful. Like the amount of maturity mismatch, the degree of complexity may itself be partly a result of the expectation of support. Once regulators have established the credibility of their commitment not to rescue, debt holders will have an incentive to monitor institutions for excessive complexity that might reduce their ability to recover their money in a bankruptcy proceeding.

Cross-Border Issues

One aspect of the complexity of systemically important institutions is that they often operate across numerous national boundaries. For example, when Lehman Brothers failed in 2008, it had activities in 40 or more countries, leading to insolvency proceedings around the world.[4]

While supervision of these global institutions is an everyday event in which cross-border matters are dealt with routinely, resolution of the institutions is a rarity, leaving room for uncertainty about what a cross-border resolution would look like. Although the optimal approach from a collective point of view is for authorities in all countries with jurisdiction over parts of the institution to cooperate in resolution to maximize the value of the institution as a whole, the incentives facing authorities may differ, since both the losses from the failure and the available assets may be of a different nature in different countries.

The possibility of multiple proceedings may be problematic due to inconsistent legal regimes in different countries or difficulties in learning about an institution's foreign-based operations. When resolution takes place within bankruptcy proceedings, cross-border coordination could be still more challenging because courts may be less apt than administrative agencies to coordinate internationally; cross-border cooperation among courts, when it occurs, typically occurs on a case-by-case basis, while financial regulators have had experience cooperating broadly on issues, including resolution policy.

Part of the answer to these concerns about multiple proceedings may be found in the notion of *country-level separability*—that is, making sure the local operations of an institution are resolvable independently of its foreign-based entities. The more self-contained and self-supporting an institution's operations within a country become, the less that cross-border issues will reduce the value of the firm in resolution, and the more credibly regulators can commit to a no-bailout policy.

Country-level separability includes the ability of local operations to function independently of a parent that is based abroad. This independence includes, for example, technology and financial support. Even partial separability—making significant progress toward independence without attaining it 100 percent—may greatly reduce the need for international coordination if the institution becomes distressed.

To be sure, separability comes at a cost, limiting the adaptability of the institution in how it uses its resources and where it positions them. Nonetheless, such costs will probably be necessary to some degree to keep cross-border issues in resolution reasonably manageable.

Transparency

Even if SIFIs achieve financing structures and organizational structures that make them resolvable, this outcome will not lead to market discipline if market participants do not believe that it has happened. Another challenge for regulators, then, is deciding whether markets will accept the agencies' own determinations about resolvability—or whether markets will need to see some of the underlying facts for themselves. In other words, regulators need to decide how much transparency in living wills is desirable.

When an institution submits a proposed living will to the Fed and the FDIC, the institution itself designates the material that will be included in the publicly released section of the document, subject to the requirements and approval of the agencies. In the view of some, the outcome of this process has generally been a minimal level of public disclosure.[5] This is consistent with financial firms wishing to disclose publicly as little as possible about their strategies and operations.

The treatment of public disclosure by regulators so far has been influenced by the longtime concern for maintaining the confidentiality of proprietary information in the supervision process. At the same time, as noted earlier, the concern for maintaining confidentiality of proprietary information must be weighed against the need for a meaningful level of disclosure about the firm's ability to be resolved without assistance. Moreover, in a democracy, voters arguably have a legitimate interest in transparency so they can assess the progress made in stabilizing the financial system.

The right level of public transparency for living wills is an open question. The Fed and the FDIC stated in August 2014 that they are jointly "committed to finding an appropriate balance between transparency and confidentiality of proprietary and supervisory information in the resolution plans" and that they will be working with SIFIs "to explore ways to enhance public transparency of future plan submissions."[6]

Conclusion

Living wills should help regulators make SIFIs resolvable through bankruptcy with minimal disruption to the economy as a whole. This will increase the credibility of policymakers' commitment not to rescue these institutions, thereby curbing the problem of "too big to fail." But regulators still face significant challenges in making these large and complex financial institutions resolvable. The challenges posed by short-term financing needs, organizational complexity, and cross-border issues may require regulators to use the enhanced authority granted to them by the Dodd-Frank Act to impose changes in firm structure that ensure resolvability. Market forces should eventually push firms toward such changes, as well—once the financial system understands that the living wills process significantly decreases the probability of bailouts. Sufficient transparency in the living wills process is key to achieving this outcome. Reconciling the need for transparency with the institutions' need for confidentiality will require careful crafting of a regulatory solution. ■

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Endnotes

1 For a classic explanation of the commitment problem, see Finn E. Kydland and Edward C. Prescott, "Rules Rather than Discretion: The Inconsistency of Optimal Plans," *Journal of Political Economy*, June 1977, vol. 85, no. 3, pp. 473–491. Research at the Richmond Fed on commitment problems in emergency lending includes Marvin Goodfriend and Jeffrey M. Lacker, "Limited Commitment and Central Bank Lending," *Economic Quarterly*, Fall 1999, vol. 85, no. 4, pp. 1–27; Kartik B. Athreya, "Systemic Risk and the Pursuit of Efficiency," Federal Reserve Bank of Richmond *2009 Annual Report*, pp. 4–20; Borys Grochulski, "Financial Firm Resolution Policy as a Time-Consistency Problem," *Economic Quarterly*, Second Quarter 2011, vol. 97, no. 2, pp. 133–152; and Jeffrey M. Lacker, "Fed Credit Policy: What is a Lender of Last Resort?" *Journal of Economic Dynamics and Control*, December 2014, vol. 49, pp. 135–138.

2 This *Economic Brief* is based on the authors' essay "Living Wills: A Tool for Curbing 'Too Big to Fail,'" Federal Reserve Bank of Richmond *2014 Annual Report*, pp. 4–17.

3 Dafna Avraham, Patricia Selvaggi, and James Vickery, "A Structural View of U.S. Bank Holding Companies," Federal Reserve Bank of New York *Economic Policy Review*, July 2012, vol. 18, no. 2, pp. 65–81.

4 Jacopo Carmassi and Richard John Herring, "Living Wills and Cross-Border Resolution of Systemically Important Banks," *Journal of Financial Economic Policy*, 2013, vol. 5, no. 4, pp. 361–387.

5 See, for example, Carmassi and Herring (2013).

6 Board of Governors of the Federal Reserve System and the Federal Deposit Insurance Corporation, "Agencies Provide Feedback on Second Round Resolution Plans of 'First-Wave' Filers," Joint press release, August 5, 2014.