Economists and policymakers are still debating the causes of and responses to the financial crisis of 2007-2008, but there is one clear point of consensus: We cannot continue to treat certain financial institutions as being “too big to fail.” Many provisions of the Dodd-Frank Act of 2010 were written with this goal in mind, and we have yet to see how effective they will be. But I believe that the provision requiring large and complex financial institutions to craft “living wills” offers the greatest potential for curtailing the ambiguous government safety net for financial institutions and putting an end to government bailouts.

Living wills are detailed plans that explain how a financial institution could be wound down under U.S. bankruptcy laws without threatening the rest of the financial system or requiring a public bailout. The plans explain how to disentangle the numerous different legal entities — sometimes numbering in the thousands — that make up a large financial firm. 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). The largest banks submitted the first drafts of their plans last summer. Regulators then pored over the thousands of pages of documents, focusing primarily on evaluating how well the firms had identified potential obstacles to resolution and understanding the key assumptions in the plans.

Planning for the resolution of a large, complex firm is difficult, painstaking work. But it is critical that regulators invest the time and energy necessary to ensure that the plans are workable and credible. Only if the plans are credible will regulators and policymakers be willing to use them in a future crisis. That willingness is essential to ending investors’ expectations of government rescues, which encouraged many firms to take on excessive risk prior to the crisis.

The Dodd-Frank Act also created the Orderly Liquidation Authority (OLA), which allows the FDIC to wind down certain troubled institutions in cases where the bankruptcy process is deemed to pose a great risk to the financial system. This authority was intended as an alternative to government rescues. But instead, the OLA still affords policymakers and regulators a great deal of discretion in determining how to treat different creditors, which further weakens the market discipline that would prevent institutions from taking on excessive risks. For this reason, I believe the use of living wills within bankruptcy is the better course. Should the creation of those plans reveal that bankruptcy would pose a risk to the system as a whole, firms may be subject to more stringent capital requirements or required to change their structure and operations such that bankruptcy is workable. An example of this would be divesting certain subsidiaries.

Some have proposed that the first step should be to break up the banks — that the way to prevent “too big to fail” is simply to make sure that the banks aren’t too big. But how do we define “too big”? The process of having firms create detailed resolution plans will enable us to map out the risks and interdependencies, and determine whether or not an institution’s size and complexity would prohibit an unassisted resolution. Living wills will provide us with an actionable roadmap.

Skeptics also have argued that living wills are little more than window dressing, an exercise that will be ignored should an institution actually become distressed. This claim, however, only reinforces the point that it is vitally important to do the work necessary to ensure that the plans offer attractive and realistic options for regulators.

The process for creating and having the Fed and FDIC assess living wills is not intended to place inordinate restrictions on an institution’s ability to take appropriate risks, or to try to make them perfectly safe from failure. Failures are going to happen despite the best efforts of regulators. With living wills, however, robust contingency planning takes place to ensure that they can occur without major disruptions to the financial system. Living wills are an important tool to help us restore market discipline, rein in the government safety net, and truly end the problem of too big to fail.

You’ll notice that this magazine, formerly Region Focus, is now called Econ Focus, a name that we believe better reflects the magazine’s mix of both national and regional coverage. But only the name has changed — Econ Focus will continue to bring you clear explanations of economic trends and important policy questions. Thank you for reading and for your continued engagement with the work of the Richmond Fed.