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Regulators, Demand Credible Living Wills Now – Not 'Ultimately'

Brad Miller

The speculation about what to expect in a second Obama term has overlooked one obvious possibility: another financial crisis.

According to JPMorgan Chase CEO Jamie Dimon, financial crises are "something that happens every five to seven years," which makes us due for the next one in the next four years. Tyler Cowen, a professor of economics at George Mason University, has said "the most important development to emerge from America's financial crisis" was that the "age of the bank run has returned," a view he ascribes to economists generally.

Rather than rely on insured deposits for financing, the biggest financial institutions now rely increasingly on the largely unregulated shadow banking system. The sheer size of shadow banking—$67 trillion, according to the Financial Stability Board—may create "a need for sudden payouts [that] could also prompt a run on a financial institution," Cowen says. "It now seems that the 21st century will resemble the 19th and early 20th centuries, with periodic panics and runs on financial institutions, perhaps followed by deflationary collapses."

All of this makes banking regulators' nonchalance about preparing for a crisis puzzling.

The Dodd-Frank Act did not break up the biggest banks into small-enough-to-fail institutions or end their reliance on shadow bank borrowing. Instead, the Act provides an "orderly resolution authority" so regulators can dismantle failing institutions without catastrophic consequences for the financial system or for the real economy.

The Act requires the largest institutions to submit resolution plans, or "living wills," to help regulators prepare. Living wills outline how institutions are organized and identify critical operations and known risks. Regulators use living wills to spot impediments to quick, orderly resolution in bankruptcy. If the plans do not show a credible way to avoid severe disruption, regulators can require tougher supervision or restructuring.

The biggest banks submitted their first living wills this summer. William Dudley, the president of the Federal Reserve Bank of New York, recently conceded that the banks' living wills "confirmed that we are a long way from the desired situation in which large complex firms could be allowed to go bankrupt without major disruptions to the financial system and large costs to society. Significant changes in structure and organization will ultimately be required for this to happen." The "initial exercise," Dudley said, provided regulators a "better understanding of the impediments to an orderly bankruptcy," and was the beginning of an "iterative process."

Simon Johnson, former chief economist for the International Monetary Fund, concluded from Dudley's remarks that the living wills process was "a sham, meaningless boilerplate and box checking." Maybe Johnson is too harsh, but "ultimately" is a very indulgent deadline in the new "age of the bank run." The uncertainties in the financial system may not allow for year after year of polite suggestions by regulators and modest tweaks by institutions.

Dudley said that the "current approach" of regulators is to reduce the likelihood that the biggest institutions might fail by requiring frequent stress tests, increased capital and liquidity buffers, and reforms to shadow banking and derivatives markets. "The bad news is that some of these efforts are just in their nascent stages," Dudley said.

The "blunter approach" of breaking up the biggest banks "may yet prove necessary," Dudley said, but it is "premature to give up on the current approach."

The "negative externalities" of the last crisis, to use Dudley's phrase, were widespread, long-term unemployment and underemployment; declining wages; the loss of decades of wealth accumulation by most families; and frightening rage that may be incompatible with enduring, stable democracy. A trial and error approach to regulation really should not be an option.

Megabanks have many incentives to remain too big to fail. They apparently enjoy immunity from criminal prosecution, even for "epic" rigging of the world's benchmark interest rates to defraud counterparties to interest rate derivatives, and for money laundering for terrorists, genocidal regimes and drug cartels. The "implicit government guarantee" provides almost unlimited liquidity for every line of business and allows megabanks to borrow more cheaply than smaller competitors. Megabanks will not voluntarily become small enough or simple enough to fail.

In fact, the most obvious impediments to orderly resolution appear intentional. The seven largest banks have 14,500 subsidiaries between them, but each megabank operates as a single enterprise with consolidated management and a common pool of capital and liquidity. As a result, every subsidiary is responsible for the liabilities of the parent corporation and all of the siblings. An obvious starting point for regulators is to require that the riskiest lines of business be conducted in separately managed, separately capitalized subsidiaries. A stand-alone subsidiary could fail without a collapse of the entire enterprise, and if the enterprise became insolvent, many subsidiaries could still operate relatively normally. Stand-alone subsidiaries would be easier to sell or spin off without serious disruption, even if the megabank is at the point of death.

The Dodd-Frank Act did not give regulators the choice of taking measures to make a panic less likely or planning for a panic. Banking regulators should act with urgency to require that living wills be credible plans to resolve failing firms without the "negative externalities" of the last crisis. Banking regulators should not wait for a protracted "iterative process" to remove obvious impediments to orderly resolution.

Rep. Brad Miller, D-N.C., is retiring after 10 years in the House.