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Too-Big-To-Fail: Living Wills or Reenact Glass-Steagall?

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Abstract

One provision of the Dodd-Frank Act of 2010 (Sec 125d) was intended to prevent a government bailout of so-called 'too big to fail' institutions in the event of material financial distress or business failure. Building on lessons learned from the financial crisis of 2008, each bank holding company or nonbank financial company with consolidated assets of $50 billion or more is designated as a Systemically Important Financial Institution (SIFI) and is required to annually submit to the Fed and FDIC a resolution plan that has come to be known as a "Living Will". The two agencies jointly review the plan to make sure that it is part of the firm's strategic plan, that it makes the complexity and interconnectivity of the firm's operations transparent, and that it will facilitate its resolution under the Bankruptcy Code.
The objective of this study is to evaluate whether the reduction of systemic risk is better achieved through Sec 125d of the Dodd-Frank Act or through the reenactment of a modern version of the Glass-Steagall Act. As an initial step, the author will review the literature on the Glass-Steagall Act to determine whether or not it was viewed as having effectively separated the banking from investment banking businesses of large financial institutions until its repeal in the late 1990s. The author will then review the feedback given by supervisory agencies on resolution plans submitted by 11 SIFIs from 2012 to 2016. The objective of this review is to understand:
1. what shortcomings the supervisory agencies have identified when they conclude that a resolution plan is *not credible* or *will not result in a rapid and orderly resolution*;
2. how the SIFIs corrected these shortcomings, and what level of corrections were later found sufficient; and
3. consequences (restrictions on activities, growth, and operations) of inability to correct the shortcomings.
A preliminary review reveals that the initial reviews by the regulatory agencies uncovered shortcomings in one or more of the following areas:

a) the firm's plan to maintain and fund material entities, critical operations, and core business lines in the event of material financial distress;
b) potential impediments to resolution, and actions to reduce its complexity and interconnectivity or make it more resolvable;
c) whether the failure of a major counterparty would likely result in the material financial distress or failure of the firm;
d) the manner and extent to which an insured depository subsidiary is adequately protected from risks arising from the activities of non-depository subsidiaries;
e) the strategy of a U.S. firm with foreign operations for addressing the risks arising from these foreign operations to its U.S. operations, and its ability to maintain core business lines and critical operations in foreign jurisdictions; and
f) whether resolution planning is sufficiently integrated into corporate governance structures and processes, subject to independent validation, and effectively supported by related MIS reporting to the board of directors and its committees.

Firms are given a chance to correct shortcomings over two 6-month follow-up reviews. In the case of Wells Fargo, the agencies imposed restrictions on the growth of its international and non-bank activities until it passed scrutiny in March 2017. However, it is not clear at this point if supervisory agencies have gone beyond making the interconnectedness or complexity of various firm's operations more transparent to stakeholders, as in actually asking for specific actions (e.g. divestiture) to reduce complexity or interconnectedness.

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