Living Wills May Kill You*

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August, 2010

The Dodd-Frank Act requires nonbank financial companies supervised by the Fed and BHCs with assets over $50 billion to report to the Fed, the Council and the FDIC plans by which the FDIC could resolve them in the case of their failure. The Fed and the FDIC then review the plans and decide whether or not they agree they are acceptable.

If they jointly decide in the case of one of those companies that it is not a credible plan, or has weaknesses, they notify the company and direct it to correct the plan. If the company fails to do so within whatever time frame is deemed appropriate by the two agencies, then those agencies may impose capital, leverage and liquidity requirements that are more stringent than otherwise required under other provisions of law, or may restrict growth, activities or operations of the company or any of its subsidiaries until it submits an acceptable plan.

If the company fails to submit an acceptable plan within 2 years after being directed to do so, and the Fed and Corporation have imposed additional requirements under the statute, the Fed and the Corporation (after consulting with the Council) may force divestiture of assets or activities of the company.

This reminds some of the old westerns in which the bad guys used to force their victims to build their own coffin. As one of them most likely said in one of those classic movies, "It seems a waste to not use this after he did such a fine job of building it."

Of course, if the good guy is not killed at that time, but lives for 25 more years, he may prosper and be too big for the coffin when he does die. That will force them to build an entirely new coffin. Or maybe they will keep their guns trained on him year after year and make him constantly rebuild the coffin each year to support his new girth.

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It is highly unlikely that any systemic risk institution will fail in the next 5-10 years, and with all of the changes that have been made by the Dodd-Frank Act, it is highly unlikely that any such institution will fail in the next 20 years, if ever. Certainly, it will not happen while the current crop of mangers and investors and regulators are still in charge, and that will stretch out at least 20 years. If reports are accurate, however, the FDIC is already searching for individuals qualified to deal with large interconnected and complex financial institutions to add to their staff to prepare for failures coming round the corner. If those failures don't happen, the FDIC will have retained on its payroll for 20 years a certain number of staff with sufficient skills to resolve those institutions. The Fed will also have retained some, but perhaps not as many. What will that staff do for 20 years when there are no failures and no signals from the Oversight Council that one or more are coming down the line?

Under the Living Will provisions, staff will be busily deciding whether the current legal and operational structures of the systemic risk institutions they are reviewing would permit tidy resolutions if they collapsed now. It is doubtful, however, that the Oversight Council will conclude that there is a significant risk that any of the systemic risk institutions will collapse in the short term. This raises questions about the usefulness of analyses based on the current structure and conditions, never mind the use of expensive dollars to make the analysis.

However, making the coffin now and then keeping it up to date may not be as expensive and wasteful as one might suspect at first blush. Changes that would have to be made as the company grew and rearranged itself over time might in fact not be substantial, since in the largest companies, most changes are usually at the margin unless a major line of business expansion occurs such as BAC acquiring the mortgage loan activity of Countrywide. So maybe there is something productive for staff to do, even though at least 20 years will go by without lowering any corpse into the coffin. Most likely, the hard work will be at the very beginning as they try to figure out what the statute means and what policies should be followed by the agencies. Once deciphered, then monitoring it and updating it over time should be fairly easy, and shouldn't require much staff time.

But bureaucracies have a way of growing, not diminishing in size. After the hard work is done in the first year or so, it is unlikely that any of the staff will make a point of insisting that their positions should be eliminated.

If they are retained, never mind that the purpose for their hiring has been met, then they must do something to prove that they are worth being paid. That is one part of the rub, since idle hands may breed mischief.

The other part of the rub is in the statute itself. It is unclear exactly what the Fed and the FDIC are directed to do. If their review of the plan submitted causes them to conclude that the plan is not "credible" (an undefined term) or would not facilitate an orderly resolution of the company under the bankruptcy code then the plan must be resubmitted to correct the deficiencies. What makes a plan "credible" or facilitates an orderly liquidation under Title 11 of the U.S. Code? Are we talking about Chapter 11? Chapter 7?

Another relevant provision of this section requires the plan to provide information regarding the manner by which the insured depository institution of the company is adequately protected from risks arising from activities of the company or its subsidiaries. Why? Is the intention to rescue the insured depository institution, or treat it differently from the rest of the organization? Is it to protect the DIF?

Taken together, it may be that Congress is directing the Fed and the FDIC to approve plans only if in bankruptcy the insured depository institution can operate independently from the rest of the company. That certainly would facilitate resolution. Implementation by the agencies under this section, therefore, might well require them to effectively place substantial firewalls of some kind between the IDI and the rest of the BHC. They can do this by commenting on the deficiencies and encouraging the company to make changes in their organization or they can do it directly if necessary by ordering the company to spin off assets or operations.

Can that possibly be what is meant? Frankly, it is a fair reading of the provisions, but is it reasonable public policy? If Congress wanted to eliminate bank holding companies by separating banks from the rest of the company, they could have done that. Sec. 23A and B are alive and well. Congress considered whether Glass-Steagall restrictions should be revived, and while many leading financial figures suggested that was a good idea, Congress chose not to do so. The language probably should be read, therefore, to provide that the agencies should be aware of the need to provide some buffers for the IDI in liquidation, but not a de facto separation of the business entities. Whatever synergies are created by having the bank as an integral part of the bank holding company should be permitted to continue.

The Fed has been given an endless number of major regulations to craft, and a similarly large number of studies either to work on directly or participate when asked by the GAO. Those regs and studies have imposed a difficult time line for the Board. It will be very busy going forward, and among the many responsibilities, it is hard to see that this one will be their highest priority.

For the FDIC, however, the agency that has the stewardship for the Deposit Insurance Fund and has been given an entirely new set of responsibilities that will require it manage the resolution of major companies with whose activities they have had no agency experience, this provision is very important. Between the two, therefore, it would not be unreasonable to expect the FDIC to work more aggressively to ensure that these rules are produced quickly and are consistent with what it sees as its statutory responsibility — i. e., resolving large banks smoothly and protecting the Deposit Insurance Fund.

It is possible that adherence to those goals under the provisions in Dodd-Frank could result in the agencies effectively sequestering the bank from the rest of the bank holding company in a situation in which there is no clear and present danger that the company is in imminent danger of failing. One would have to assume that this would make the operation of the company less efficient, and less of an engine for economic growth. It also is more apt to increase its chance of failure, or the chances of failure of an affiliate, although one must assume that the risk created could be spotted and avoided if it were too great.

That needn't be the case, of course, but it could become the case depending upon the interpretations by the Fed and the Corporation of their responsibilities under the Act, and their decisions on how they implement them.

So unless care is taken in implementing the Living Will sections, creating a method to make it easier to resolve the failure of a company may increase the risk that the company will fail to produce efficiently, all because sometime in the somewhat distant future the institution might find itself in difficulty.

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