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Living Wills: How Legal Entity Rationalization Addresses the “Too Big to Fail” Problem

I. INTRODUCTION

Regulations implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”) resolution plan requirement—commonly referred to as “living will” requirement—were finalized just over five years ago by the Federal Reserve Board (the “Fed”) and the Federal Deposit Insurance Corporation (the “FDIC”) (collectively, the “Agencies”).¹ The living will requirement is one device in an arsenal of regulatory provisions designed to solve the “too big to fail” (“TBTF”) problem.² A financial institution is considered TBTF if the government would be compelled to intervene to prevent it from failing because such failure would devastate the economy.³ The living will requirement aims to address TBTF by requiring “covered companies”⁴ to design and implement procedures that would allow the company to execute a “rapid and orderly resolution”⁵ in the event of material financial distress or failure.⁶ If a living will does not reflect the

1. Resolution Plans Required, 26 Fed. Reg. 67323, 67323 (Nov. 1, 2011) (codified at 12 C.F.R. pt. 243).

2. See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §1, 124 Stat. 1376, 1376 (2010) (listing the goal to end TBTF as one of the purposes for the Act).

3. See U.S. GOV’T ACCOUNTABILITY OFFICE, GAO-16-341, RESOLUTION PLANS: REGULATORS HAVE REFINED THEIR REVIEW PROCESSES BUT COULD IMPROVE TRANSPARENCY AND TIMELINESS 2 n.5 (2016) [hereinafter GAO-16-341], <http://www.gao.gov/assets/680/676497.pdf> (defining TBTF as “a market notion that the federal government would intervene to prevent the failure of a systemically important financial institution (“SIFI”) to avoid harm to the economy”).

4. See Resolution Plans, 12 C.F.R. § 243.2(f) (2016) (defining each nonbank financial company supervised by the Federal Reserve System Board of Governors and each bank holding company with \$50 billion or more total consolidated assets as a “covered company”).

5. See Resolution Plans Required, 26 Fed. Reg. at 67327 (defining a rapid and orderly resolution as a resolution that can be completed in a reasonable period of time and that “substantially mitigates the risk that the failure of the company would have serious adverse effects on financial stability in the United States”).

6. See BD. OF GOVERNORS OF THE FED. RESERVE SYS. & FED. DEPOSIT INS. CORP., RESOLUTION PLAN ASSESSMENT FRAMEWORK AND FIRM DETERMINATIONS 5 (2016)

ability of the company to proceed through an orderly resolution, the Agencies will deem the plan “not credible.”⁷

The eight largest bank holding companies in the nation—JP Morgan Chase & Co., Morgan Stanley, State Street Corp., Wells Fargo, Goldman Sachs, Citigroup, Bank of New York Mellon, and Bank of America—received the results of their 2015 living will submissions in April 2016.⁸ The Agencies found deficiencies in five of the eight living wills and concluded that those plans were not credible.⁹ Two banks received split decisions on credibility, and Citigroup was the only bank to pass muster under the prescribed criteria.¹⁰ After three annual submission-and-review cycles since 2012, it has become clear that the nation’s largest banks are still TBTF.¹¹

Due to the perceived lack of progress toward creating credible plans, critics are calling on the Agencies to use the authority granted to them under Dodd-Frank to apply more restrictive prudential requirements¹² to the companies whose plans are not credible.¹³ In response, the Agencies announced that banks that failed to remedy deficiencies in their 2015 living wills by October 2016 would be subject to “more stringent capital, leverage, or liquidity requirements or

[hereinafter FRAMEWORK AND DETERMINATIONS] (stating that the goal of resolution is to make sure that failure of a bank holding company doesn’t have seriously adverse effects on financial stability in the United States).

7. See Resolution Plans Required, 26 Fed. Reg. at 67325.

8. FRAMEWORK AND DETERMINATIONS, *supra* note 6, at 13.

9. Press Release, Bd. of Governors of the Fed. Reserve Sys., Agencies Announce Determinations and Provide Feedback on Resolution Plans of Eight Systemically Important, Domestic Banking Institutions (Apr. 13, 2016), <https://www.federalreserve.gov/newsevents/press/bcreg/20160413a.htm>.

10. DELOITTE, PEELING BACK THE 2017 RESOLUTION PLAN GUIDANCE 4 (2016), <https://www2.deloitte.com/content/dam/Deloitte/us/Documents/regulatory/us-regulatory-resolution-plan-guidance.pdf>.

11. Thomas M. Hoenig, Vice Chairman, F.D.I.C., Bd. Meeting Statement (Apr. 13, 2016), <https://www.fdic.gov/news/news/speeches/spapr1316a.html> (concluding that “the goal to end too big to fail and protect the American taxpayer by ending bailouts remains just that: only a goal”).

12. Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”) §165(d), 12 U.S.C §5365(d)(5)(A) (authorizing the Agencies to subject firms that fail to submit credible plans to more stringent capital, leverage, or liquidity requirements, or restrictions on the growth, activities, or operations of the company, or any subsidiary thereof, until such time as the company resubmits a plan that remedies the deficiencies).

13. Press Release, Elizabeth Warren, U.S. Senator, Donnelly, Warren Encourage Fed, FDIC to Consider All Statutory Tools if Banks’ Living Wills Are Found Not Credible (June 20, 2016) [hereinafter Warren Press Release], https://www.warren.senate.gov/?p=press_release&id=1162.

restrictions on growth, activities, or operations.”¹⁴ Then, in December 2016, the Agencies subjected Wells Fargo to various limitations on future growth after the company failed to address its living will deficiencies in an updated submission.¹⁵

Though a majority of the nation’s largest banks are not fully prepared for orderly resolution, the living wills process has yielded demonstrable progress toward remedying TBTF.¹⁶ Banks have been forced to simplify organizational structure and operations in their efforts to pass the Agencies’ review.¹⁷ The examination of one section of the living wills—legal entity rationalization (“LER”)—illustrates the progress made to date and highlights the potential improvements in bank safety and soundness that the living will requirement will provide going forward.

LER requires firms to organize and align material entities with critical operations and core business lines in order to address one of the most hazardous aspects of TBTF: complexity.¹⁸ LER is just one part of the living will evaluation process, but the significant improvements that banks have made in this area exemplify the efficacy of the living will requirement. Consequently, this Note concludes that the Agencies should remain conservative in applying stringent prudential requirements to the banks for two reasons. First, the living will submission and review process has had a significant impact on the TBTF problem, and second, further regulatory constraints may increase the risk of market harm.¹⁹

14. Bd. of Governors of the Fed. Reserve Sys., *supra* note 9.

15. See *infra* Part II.

16. See *e.g.*, Letter from Bd. of Governors of the Federal Reserve System & F.D.I.C to Gerald Hassell, Chairman and Chief Executive Officer of The Bank of New York Mellon Corp. 10 (Apr. 12, 2016) [hereinafter BNYM 2016 Letter] (listing steps taken by Bank of New York Mellon to become resolvable without government aid).

17. See FIN. STABILITY OVERSIGHT COUNCIL, STUDY OF THE EFFECTS OF SIZE AND COMPLEXITY OF FINANCIAL INSTITUTIONS ON CAPITAL MARKET EFFICIENCY AND ECONOMIC GROWTH 25 (2016) [hereinafter SIZE AND COMPLEXITY] (stating that firms have explored ways to streamline and simplify organizational structures through resolution planning process).

18. See Hal S. Scott, *Interconnectedness and Contagion* 5–19 (2012) [hereinafter INTERCONNECTEDNESS AND CONTAGION], https://www.aei.org/wp-content/uploads/2013/01/-interconnectedness-and-contagion-by-hal-scott_153927406281.pdf (listing size, interconnectedness, and complexity as features that warrant the designation of a large financial institution as systemically important).

19. See Natasha Sarin & Lawrence Summers, *Have Big Banks Gotten Safer?*, BROOKINGS PAPERS ON ECONOMIC ACTIVITY (forthcoming 2017) (manuscript at 27), <https://>

This Note proceeds in five parts. Part II provides an overview of the living will requirement, describes the review process that the Agencies use to make their credibility determinations, and explains the LER section of the living will.²⁰ Part III analyzes how the LER process has enabled the simplification of bank structure and operations, thereby resolving many of the complexity problems.²¹ Part IV compares the likely effects, advantages, and drawbacks of subjecting the covered companies to more restrictive prudential requirements when their living wills do not pass the Agencies' scrutiny.²² Part V concludes by emphasizing the effectiveness of the living will requirement and cautions against the enforcement of more stringent prudential requirements at this stage in the regulation's evolution.²³

II. OVERVIEW OF LIVING WILLS AND LEGAL ENTITY RATIONALIZATION

A. *Requirements and Review Process*

Bank holding companies with total consolidated assets of \$50 billion or more and nonbank financial companies designated by the Financial Stability Oversight Council (the "FSOC") for supervision by the Fed are required to submit living wills annually.²⁴ The Agencies set three yearly due dates staggered by the asset size of the banking entity.²⁵ The first group includes any company with \$250 billion or more in total nonbank assets.²⁶ The eight largest bank holding companies—Bank of America, Wells Fargo, JP Morgan & Chase, State Street Bank, Bank of New York Mellon, Goldman Sachs, Morgan Stanley, and Citigroup—are first wave filers.²⁷ Each living will must include a "narrative" section that contains detailed analyses of strategies and processes

www.brookings.edu/wp-content/uploads/2016/09/2_sarinsummers.pdf (discussing impact of bank regulatory actions on national market).

20. *See infra* Part II.

21. *See infra* Part III.

22. *See infra* Part IV.

23. *See infra* Part V.

24. Resolution Plans, 12 C.F.R. § 243.2(f) (2016).

25. *Id.* § 243.3(a).

26. *Id.* §243.3(a)(1).

27. BD. OF GOVERNORS OF THE FED. RESERVE SYS., SR 14-8, CONSOLIDATED RECOVERY PLANNING FOR CERTAIN LARGE DOMESTIC BANK HOLDING COMPANIES 1 (Sept. 25, 2014) [hereinafter SR 14-8].

targeted to address the key areas of concern identified by the Agencies as vital to an orderly resolution.²⁸

The FDIC has a resolution plan requirement, separate from the Dodd-Frank living will mandate, that applies to insured depository institutions only.²⁹ The FDIC rule requires insured depository institutions with \$50 billion or more in total consolidated assets to develop living wills that will facilitate resolution under the Federal Deposit Insurance Act.³⁰ The FDIC requirement is intended to coordinate the resolution of an insured depository institution and its parent holding company, allowing covered firms to submit a consolidated report sufficient to satisfy both laws.³¹

Further, the Dodd-Frank living will requirement will be used as a planning tool to allow the FDIC to exercise its power under the Orderly Liquidation Authority (“OLA”) efficiently.³² Previously, the FDIC only had authority to resolve insured depository institutions, but Dodd-Frank created the OLA to give the FDIC authority to resolve a systemically important nonbank financial institution that has failed.³³

The Government Accountability Office (the “GAO”) published a report to provide insight into the living will review process conducted by the Agencies.³⁴ First, each plan is subject to a completeness, vertical, and horizontal review.³⁵ The completeness review is a two-week process during which regulators use checklists to verify that all required documentation and basic information have been submitted by

28. See FED. DEPOSIT INS. CORP. & BD. OF GOVERNORS OF THE FED. RESERVE SYS., GUIDANCE FOR 2017 §165(d) ANNUAL RESOLUTION PLAN SUBMISSIONS BY DOMESTIC COVERED COMPANIES THAT SUBMITTED RESOLUTION PLANS IN JULY 2015 2 (2016) [hereinafter GUIDANCE 2017], <https://www.federalreserve.gov/newsevents/press/bcreg/bcreg20160413a1.pdf> (outlining six key areas of concern: capital, liquidity, governance, operations, derivatives and trading, and legal entity rationalization).

29. Resolution Plan Required, 76 Fed. Reg. 67323, 67329 (Nov. 1, 2011) (codified at 12 C.F.R. pt 243).

30. *Id.*

31. See e.g., CITIGROUP, 2014 RESOLUTION PLAN FOR CITIGROUP INC. & CITIBANK, N.A. 1 (June 20, 2014), <https://www.federalreserve.gov/bankinforeg/resolution-plans/citigroup-1g-20140701.pdf> (titling document as §165(d) and IDI Resolution Plan).

32. Fed. Deposit Ins. Corp., *The Orderly Liquidation of Lehman Brothers Holdings Inc. Under the Dodd-Frank Act*, 5 FDIC QUARTERLY no. 2, 2011, at 41 (describing how resolution plan would have provided insight required to plan orderly resolution of Lehman Brothers Holdings).

33. *Id.* at 31.

34. GAO-16-341, *supra* note 3.

35. GAO-16-341, *supra* note 3.

each company.³⁶ The vertical review identifies shortcomings and deficiencies in an individual company's living will, and the horizontal review tracks issues that arise across all living wills.³⁷ Following each review, regulators prepare summaries of each living will, which are reviewed at a higher level by both the Oversight Group³⁸ and the Resolution Plan Vetting Committees³⁹ at the FDIC and the Fed respectively.⁴⁰ Finally, the Board of Directors for the FDIC and the Federal Reserve Board of Governors vote on the credibility of plans, using the summaries prepared by regulators.⁴¹

The GAO report included two areas of concern and recommendations for the Agencies to consider, the first of which addressed the lack of transparency in the credibility determination process.⁴² The GAO suggested that the Agencies release the framework used to make decisions about the adequacy of living will submissions.⁴³ In response to this feedback, the Agencies released a public document with a list of the major parts of the plans and a short explanation of what each part requires. However, no framework for determining credibility has been released.⁴⁴

B. *Results of Past Submissions*

As projected, the living wills process has been an iterative one, which has allowed the banks to improve their plans by implementing tailored feedback.⁴⁵ To achieve this, the Agencies required first wave filers to submit initial plans by July 1, 2012.⁴⁶ The Fed made it clear

36. GAO-16-341, *supra* note 3, at 18.

37. See GAO-16-341, *supra* note 3, at 18–19 (describing vertical review as a firm specific review which identifies “issues, shortcomings, and obstacles to resolvability” and horizontal review identifies key issues across all plans which informs general guidance).

38. An interdivisional group of senior executives that directs review of staff-level shortcomings and recommends findings to the FDIC Board of Directors. GAO-16-341, *supra* note 3, at 20.

39. See GAO-16-341, *supra* note 3, at 20 (describing the Fed’s Resolution Plan Vetting Committee which performs same tasks as FDIC’s Oversight Group).

40. GAO-16-341, *supra* note 3, at 20.

41. GAO-16-341, *supra* note 3, at 20–21.

42. GAO-16-341, *supra* note 3, at 56–57.

43. GAO-16-341, *supra* note 3, at 56–57.

44. FRAMEWORK AND DETERMINATIONS, *supra* note 6.

45. See FRAMEWORK AND DETERMINATIONS, *supra* note 6, at 13 (“The resolution plan rule established an iterative process . . .”).

46. See Resolution Plan Required, 12 C.F.R. § 243.3(a)(i) (2016) (setting July 2012

that it would issue individualized advice to help improve each company's structure and operations based upon the first plan in order to provide guidance and direction for future submissions.⁴⁷ Accordingly, the companies' 2012 submissions were not evaluated for credibility.⁴⁸ Instead, the Agencies completed a horizontal review and released a guidance document with specific instructions, including key considerations that each firm should address in the narrative section of subsequent plans.⁴⁹

Despite overall improvements in the 2013 living will submissions, the Agencies' reviews—which were not released until August 2014—noted deficiencies in each company's plan.⁵⁰ The Fed determined that each bank had shortcomings that should be addressed, while the FDIC felt that the deficiencies were enough to deem the plans not credible.⁵¹ The law dictates that both the FDIC and the Fed agree before a credibility determination prevails, therefore the banks received another opportunity to satisfy the living will requirements.⁵² The Agencies provided feedback for the banks to use while preparing their July 2015 living wills.⁵³ In addition, staff at both Agencies were available to answer questions related to living will preparation.⁵⁴

The iterative nature of the living wills process has allowed the

due date for any covered company that has \$250 billion or more in total nonbank assets).

47. See GAO-16-341, *supra* note 3, at 9–10 (“The Board of Governors noted that . . . the initial resolution plans would provide the foundation for developing more robust plans over the next few years.”).

48. *But see* Hal Scott, *The Mystery of ‘Living Will’ Rules for Banks*, WALL ST. J. (Sept. 3, 2014), <http://www.wsj.com/articles/hal-scott-the-mystery-of-living-will-rules-for-banks-1409786558> (asserting that the Agencies undermine the living will process by failing to provide clear guidance on how to achieve credibility).

49. FED. DEPOSIT INS. CORP. & BD. OF GOVERNORS OF THE FED. RESERVE SYS., GUIDANCE FOR 2013 §165(d) ANNUAL RESOLUTION PLAN SUBMISSIONS BY DOMESTIC COVERED COMPANIES THAT SUBMITTED INITIAL RESOLUTION PLANS IN 2012 1 (2013) [hereinafter GUIDANCE FOR 2013], <https://www.federalreserve.gov/newsevents/press/bcreg/bcreg20130415c2.pdf>.

50. Press Release, Fed. Deposit Ins. Corp. & Bd. of Governors of the Fed. Reserve Sys., Agencies Provide Feedback on Second Round Resolution Plans of “First-Wave” Filers (Aug. 5, 2014), <http://www.federalreserve.gov/newsevents/press/bcreg/20140805a.htm>.

51. *Id.*

52. *Id.*

53. *Id.*

54. Letter from Board of Governors of the Fed. Reserve Sys. & the Fed. Deposit Ins. Corp. to Lloyd Blankfein, Chairman and Chief Exec. Officer of The Goldman Sachs Group, Inc. 3 (Apr. 12, 2016) [hereinafter GS 2016 Letter], <https://www.federalreserve.gov/newsevents/press/bcreg/goldman-sachs-letter-20160413.pdf>.

Agencies to take an active role in shaping each bank's recovery and resolution process.⁵⁵ Between the guidance issued in 2013 and 2016, the Agencies refined the focus of their assessments⁵⁶ and identified six key areas of concern that each company must thoroughly address: capital, liquidity, governance, operations, derivatives and trading activities, and LER.⁵⁷ Though earlier feedback emphasized quality and scope of living wills, more recent feedback has focused on changes that companies have made or failed to make in the six main areas.⁵⁸ While attentiveness to each area of concern is vital to an orderly resolution, LER addresses the heart of TBTF, namely, the size and complexity arising from the organizational structure of an institution.⁵⁹

C. *Legal Entity Rationalization*

LER is described by the Agencies as the process of simplifying the legal entity structure of a corporation in a way that facilitates a rapid and orderly resolution.⁶⁰ The process involves four main tasks: developing resolution-focused LER criteria, establishing a governance procedure to realign current material entities in accordance with those criteria, ensuring ongoing adherence to LER criteria, and devising plans to enable separate resolution for each material entity in a bank's structure.⁶¹ LER criteria are guidelines used to simplify the hierarchy of material entities, and to align those entities with critical operations and core business lines in a way that best meets the needs of a firm's resolution strategy.⁶² To meet the Agencies' expectations, LER criteria

55. ARANTXA JARQUE & DAVID A. PRICE, FEDERAL RESERVE BANK OF RICHMOND, *LIVING WILLS: A TOOL FOR CURBING TOO BIG TO FAIL* 4, 9 (2014), https://www.richmondfed.org/-/media/richmondfedorg/publications/research/annual_report/2014/pdf/ar.pdf.

56. GAO-16-341, *supra* note 36.

57. *FRAMEWORK AND DETERMINATIONS*, *supra* note 17, at 10.

58. PWC, *FIRST TAKE, TEN KEY POINTS FROM REGULATORS' FEEDBACK TO WAVE 1 RESOLUTION PLAN FILERS 2* (2014), <http://www.pwc.com/us/en/financial-services/regulatory-services/publications/assets/first-take-dodd-frank-act-resolution-planning.pdf>.

59. *See* ARANTXA JARQUE & DAVID A. PRICE, FEDERAL RESERVE BANK OF RICHMOND, *LIVING WILLS FOR SYSTEMICALLY IMPORTANT FINANCIAL INSTITUTIONS: SOME EXPECTED BENEFITS AND CHALLENGES 3* (2015) (describing the relationship between large institutions and complexities involved with their resolution).

60. *FRAMEWORK AND DETERMINATIONS*, *supra* note 6, at 10.

61. *GUIDANCE 2017*, *supra* note 28.

62. *See* *FRAMEWORK AND DETERMINATIONS*, *supra* note 6, at 1.

must be clear, actionable, and focused on resolution considerations.⁶³ Resolution-focused criteria will enable: (1) recapitalization and liquidity support of material entities; (2) provide for the sale, transfer, or wind-down of discrete operations; (3) prioritize protection of all insured depository institutions; and (4) ensure minimal complexity throughout the firm's hierarchy.⁶⁴

After designing LER criteria sufficient to meet their resolution goals, banks must establish a governance process to apply the criteria to their current holding company structure and to ensure ongoing adherence to them.⁶⁵ This means that firms must implement their LER criteria to simplify and prepare the existing corporate structure for resolution,⁶⁶ and they must consult their LER criteria as they grow or decide to add new business lines.⁶⁷ The Agencies emphasized how vital it is that business-as-usual (profit-focused) considerations, which usually motivate decisions to expand activities or add new entities, do not eclipse the consideration of LER and orderly resolution.⁶⁸

In addition to bringing the corporate structure into alignment with LER criteria, the banks must develop options to sell or transfer material entities and business lines in a piecemeal fashion.⁶⁹ To accomplish this, the bank must identify all material entities⁷⁰ and detail

63. Letter from Board of Governors of the Fed. Reserve Sys. & the Fed. Deposit Ins. Corp. to James Dimon, Chairman and Chief Exec. Officer of JP Morgan Chase & Co. 19 (Apr. 12, 2016) [hereinafter JP Morgan Chase 2016 Letter].

64. See GUIDANCE 2017, *supra* note 28, at 10 (setting out list of priorities that LER criteria should achieve when applied to a corporation's structure and activities).

65. See GUIDANCE 2017, *supra* note 28, at 20 (“[T]he plan should include a description of the firm's legal entity rationalization governance process.”).

66. See BNYM 2016 Letter, *supra* note 16, at 10 (discussing how firms are expected to evaluate their legal entity structures against their rationalization criteria and make appropriate adjustments and thereby implement their criteria).

67. See Letter from Bd. of Governors of the Fed. Reserve Sys. & the Fed. Deposit Ins. Corp. to John Stumpf, Chairman and Chief Exec. Officer of Wells Fargo & Co. 8 (Apr. 12, 2016) [hereinafter WF 2016 Letter], <https://www.federalreserve.gov/newsevents/press/bcreg/wells-fargo-letter-20160413.pdf>

(emphasizing that application of LER criteria should allow firm to prioritize resolution when determining which projects to undertake).

68. *Id.*

69. See GUIDANCE 2017, *supra* note 28, at 14 (“The firm should identify discrete operations that could be sold or transferred in resolution.”).

70. See GUIDANCE FOR 2013, *supra* note 49, at 10 (“Material entities should encompass those entities, including foreign offices and branches, that are significant to the maintenance of a critical operation or core business line.”).

how critical operations⁷¹ are supported by each.⁷² Further, the interconnections and shared services between each material entity must be mapped along with a plan to address disruptions of shared services caused by any sale or transfer that would impact multiple entities.⁷³ The goal of separability is to enable a firm to wind down activities of a failed company without any negative impact on the stability of any solvent material entities or critical operations that remain.⁷⁴

The Fed placed additional emphasis on the separability facet of LER in the context of recovery planning in a 2014 supervisory letter directed to the eight largest banks.⁷⁵ Recovery planning is distinct from resolution planning in that it enables a bank to respond to financial catastrophes by taking actions to stabilize the firm and prevent it from failing.⁷⁶ The separability options devised for resolution should be supported by the same analysis required for recovery planning.⁷⁷ This means that the living will should discuss mitigating actions for all relevant obstacles to the sale or transfer of significant assets or legal entities.⁷⁸ Examples of possible impediments include: interconnectivity among operations that may suffer interruption during the sale of a legal entity, market conditions that might affect availability of buyers or going concern value of assets, or tax and regulatory consequences connected to the sale, transfer, or wind-down of an entity.⁷⁹

Banks that carefully incorporated agency guidelines for establishing LER criteria and implementation received a favorable assessment for this portion of their 2015 plans.⁸⁰ For example,

71. See GAO-16-341, *supra* note 3, at 14–21 (referencing the final rule which defines critical operations as “the operations of a company for which the failure or discontinuance would pose a threat to the financial stability of the United States”).

72. GUIDANCE FOR 2013, *supra* note 49, at 4.

73. GUIDANCE FOR 2013, *supra* note 49, at 12.

74. GUIDANCE FOR 2013, *supra* note 49, at 4.

75. SR 14-8, *supra* note 26, at 1.

76. SR 14-8, *supra* note 26, at 1.

77. See GUIDANCE 2017, *supra* note 28, at 19 (“[T]he plan should include a description of the firm’s legal entity rationalization governance process.”).

78. SR 14-8, *supra* note 27, at 1.

79. SR 14-8, *supra* note 27, at 1.

80. See, e.g., Letter from Bd. of Governors of the Fed. Reserve Sys. & the F.D.I.C to James Gorman, Chairman and Chief Exec. Officer of Morgan Stanley 5 (Apr. 14, 2016) [hereinafter MS 2016 Letter], <https://www.federalreserve.gov/newsevents/press/bcreg/morgan-stanley-letter-20160413.pdf> (acknowledging Morgan Stanley for developing specific LER criteria which focus on resolvability of the firm, reducing number of legal entities, separating and simplifying structure of operations).

Citigroup received commendation for developing specific LER criteria, identifying discrete objects to sell, and reducing its asset size.⁸¹ Further, Citigroup reduced its number of business lines, thereby reducing its total number of legal entities by 40%.⁸² The firm also plans to reduce its number of legal entities by an additional 25% before the July 2017 living will submission.⁸³ Accordingly, the Agencies did not find any deficiencies or shortcomings in this area of Citigroup's submission.⁸⁴

On the other hand, firms that did not design specific, actionable LER criteria, failed to implement their criteria, or did not adequately describe the governance process for continued adherence to LER, received poor reviews from the Agencies.⁸⁵ For example, Wells Fargo was tasked with redesigning its LER criteria because the previous criteria prioritized business-as-usual concerns, such as tax advantages and regulatory arbitrage, over resolvability considerations.⁸⁶ In addition to rethinking LER criteria, the Agencies directed the bank to set out the governance process it will use to ensure that the criteria are applied on an ongoing basis.⁸⁷ This illustrates that the living will process is much more than a "fig leaf for TBTF."⁸⁸ To the contrary, the regulators fully expect the banks to make all changes necessary to bring operations in line with their chosen resolution strategy.

Wells Fargo received another opportunity to demonstrate that it had progressed and cured the LER deficiencies in its October 2016 living will submission.⁸⁹ In the public portion of its latest submission, the bank reported the development of clear, actionable, resolution-focused LER criteria with accompanying rationale and application

81. Letter from Bd. of Governors of the Fed. Reserve Sys. & the F.D.I.C to Michael O'Neill, Chairman, and Michael Corbat, Chief Exec. Officer of Citigroup Inc. 4 (Apr. 12, 2016) [hereinafter Citigroup 2016 Letter], <https://www.federalreserve.gov/newsevents/press/bcreg/citi-letter-20160413.pdf>.

82. CITIGROUP, CITIGROUP INC. RESOLUTION PLAN PUBLIC SECTION, 19 (July 1, 2015), <https://www.fdic.gov/regulations/reform/resplans/plans/citi-165-1507.pdf>.

83. *Id.*

84. Citigroup 2016 Letter, *supra* note 81, at 4.

85. WF 2016 Letter, *supra* note 67, at 8.

86. WF 2016 Letter, *supra* note 67, at 8.

87. WF 2016 Letter, *supra* note 67, at 8.

88. Barbara A. Rehm, *The Dodd-Frank Act's Curious Bequest: The Living Will*, AM. BANKER (Sept. 23, 2010) (asserting that the living will requirement is nothing more than a fig leaf for TBTF).

89. See WF 2016 Letter, *supra* note 67, at 9 (listing actions that Wells Fargo must complete before October 2016 submission to remedy deficiencies).

protocols for each.⁹⁰ Wells Fargo used external industry experts in addition to an internal workgroup staffed with subject matter experts to review the bank's LER criteria.⁹¹ To address the deficiency in its LER governance process, the firm created several procedures and new practices.⁹² One of these is an application protocol to be used to help management apply the LER criteria on an ongoing basis.⁹³ Another notable improvement was the event-driven legal entity assessment decision tree, which describes the process to be used when making decisions that will affect the corporate structure.⁹⁴ The decision tree includes a list of business decisions—such as mergers or acquisitions, new products, or geographic expansion—that might trigger the need for assessment.⁹⁵

The Agencies determined that the aforementioned procedures and processes did not adequately address the LER deficiencies found in Wells Fargo's 2015 living will, and the redesigned LER criteria failed to address specific obstacles to resolution in connection with the firm's resolution strategy.⁹⁶ The examples provided in the event-driven legal entity assessment decision tree were deemed inadequate because they did not include precise actions that management could take to align legal entities and business lines.⁹⁷ In one example, the application of LER criteria to a current business line only triggered the need for additional research by management, instead of a weighing of obstacles and vulnerabilities associated with resolution that the business line presented.⁹⁸ A better way to show that LER criteria are clear and actionable, in the Agencies' view, would have been to include examples of how the criteria could be applied in a way that would facilitate resolution, a showing that the current alignment is resolvable under the

90. WELLS FARGO & CO., 2016 RESOLUTION PLAN PUBLIC SECTION 13 (2016), <https://www.federalreserve.gov/bankinforeg/resolution-plans/wells-fargo-2g-20161001.pdf>.

91. *Id.*

92. *Id.*

93. *Id.* at 14.

94. *Id.*

95. *Id.*

96. See Letter from Bd. of Governors of the Fed. Reserve Sys. & the F.D.I.C to Timothy Sloan, Chief Exec. Officer and President of Wells Fargo & Co., 1 (Dec. 13, 2016) [hereinafter, WF Dec. 2016 Letter] (“[T]he Agencies have jointly determined that the 2016 Submission does not adequately remedy the deficiencies related to LER Criteria . . .”).

97. See *id.* (discussing the inadequacies of the assessment framework).

98. *Id.* at 4.

bank's current strategy, or analysis of how the criteria mitigate risks to orderly resolution.⁹⁹

Wells Fargo is the first company to be penalized due to living will deficiencies.¹⁰⁰ The bank is currently forbidden from establishing foreign banks or foreign branches and acquiring any nonbanking subsidiaries.¹⁰¹ Further, if the deficiencies are not cured by March 2017, then Wells Fargo's nonbank entity and broker-dealer total asset size will be limited to the level reported in September 2016.¹⁰² The Fed decided to restrict activities three months after its investigation into illegal banking practices perpetrated by Wells Fargo employees began, although the Agencies insist that the sanctions were unrelated to the firm's sham-accounts fraud.¹⁰³ Nonetheless, it is difficult to reconcile this credibility determination in light of the progress Wells Fargo has made toward simplifying its structure and operations.

Evaluating the propriety of the Agencies' decision is challenging for several reasons. First, as the GAO espoused in its report on the living will process, the Agencies and the banks refuse to disclose much detail to the public about the contents of the living wills.¹⁰⁴ As a result, a balanced assessment of Wells Fargo's—or any covered company's—progress year after year is not possible, and the public must rely on the Agencies to report this information.¹⁰⁵ Second, even increased disclosure may not provide the means necessary to evaluate progress because many living wills are said to be over 10,000 pages

99. See *id.* at 5–6 (listing ways that Wells Fargo could have demonstrated that the LER criteria it developed would be clear and actionable during resolution).

100. Ryan Tracy, *Wells Fargo Sanctioned by U.S. Regulators for 'Living Will' Deficiencies*, WALL ST. J. (Dec. 13, 2016), <http://www.wsj.com/articles/u-s-regulators-sanction-wells-fargo-declaring-living-will-deficiencies-1481664744>.

101. WF Dec. 2016 Letter, *supra* note 96, at 9.

102. WF Dec. 2016 Letter, *supra* note 96, at 10.

103. See Michael Corkery, *Wells Fargo Fined \$185 Million for Fraudulently Opening Accounts*, N.Y. TIMES (Sept. 8, 2016), <http://www.nytimes.com/2016/09/09/business/dealbook/wells-fargo-fined-for-years-of-harm-to-customers.html> (reporting that Wells Fargo employees engaged in illegal banking practices that involved opening nearly two million fraudulent banking and credit card accounts without customer consent).

104. See JARQUE & PRICE, *supra* note 59, at 4 (reporting that the banks decide what to include in the public sections of the living wills and that the level of disclosure has been minimal).

105. See JARQUE & PRICE, *supra* note 59, at 4 (“[M]aintaining confidentiality must be weighed against the need for a meaningful level of disclosure about the firm's ability to be resolved without assistance.”).

long.¹⁰⁶ Third, the Agencies have not disclosed their framework for assessing deficiencies to covered companies or the public, which is necessary to determine whether the credibility determinations are made using objective criteria.¹⁰⁷ Despite these gaps in information, the publicly available documents that report the progress made by Wells Fargo and other covered companies depict an industry that is investing substantial resources to remedy the complexity inherent with TBTF.¹⁰⁸

III. HOW LEGAL ENTITY RATIONALIZATION REMEDIES COMPLEXITY OF LARGE FINANCIAL INSTITUTIONS

A. *LER Addresses Structural Complexity*

Many of the complications caused by disorderly resolution of large firms stem from the vast number of legal entities in their corporate structures, which make it difficult to organize and consolidate legal proceedings.¹⁰⁹ Cautionary examples of such difficulties abound in various accounts of the largest corporate failures in U.S. history, the most notable of which is the collapse of Lehman Brothers Holdings (“Lehman”).¹¹⁰ When Lehman filed for bankruptcy in September 2008, there were over 400 subsidiaries¹¹¹ in more than forty jurisdictions under the company’s structure.¹¹² The structure of material entities—likely driven by tax, accounting, and regulatory advantages without regard to resolution considerations¹¹³—led to seventy-five different bankruptcy proceedings¹¹⁴ with some actions occurring concurrently on

106. See JACOPO CARMASSI & RICHARD J. HERRING, CORPORATE STRUCTURES, TRANSPARENCY AND RESOLVABILITY OF GLOBAL SYSTEMICALLY IMPORTANT BANKS 160 (Aug. 2014) (“Many documents submitted are reported to exceed ten thousand pages in length . . .”).

107. See GAO-16-341, *supra* note 3, at 27 (reporting that the Agencies have not disclosed frameworks to plan filers or to the public).

108. See *e.g.*, WELLS FARGO & CO., *supra* note 90, at 13 (detailing formation of internal living will oversight office in addition to consultation with external resolution experts).

109. JARQUE & PRICE, *supra* note 55, at 13.

110. INTERCONNECTEDNESS AND CONTAGION, *supra* note 18, at 19.

111. INTERCONNECTEDNESS AND CONTAGION, *supra* note 18, at 211.

112. Nizan Pakin, *The Case Against Dodd-Frank Act’s Living Wills Contingency Planning Following the Financial Crisis*, 9 BERKELEY BUSINESS L.J. 29, 81 (2014).

113. See CARMASSI & HERRING, *supra* note 106, at 153 (explaining why global institutions adopt complex legal structures without regard for possible obstacles to orderly resolution).

114. CARMASSI & HERRING, *supra* note 106, at 153.

three continents.¹¹⁵

Citigroup is substantially larger and more globally active than Lehman.¹¹⁶ However, the living will process, and more specifically the LER requirement, has prompted Citigroup to streamline its operations and downsize where possible to mitigate obstacles that would otherwise impede resolution.¹¹⁷ For instance, after identifying core business lines, critical operations, and material entities, Citigroup sold non-core business lines and subsidiaries and divested assets in various domestic and foreign businesses.¹¹⁸ Although Citigroup has retained a substantial number of entities, LER has improved the way that the firm organizes and manages those entities by bringing recovery and resolution to the forefront of corporate activity.¹¹⁹ This trend holds true to varying degrees for all eight of the covered companies.

Despite the costly efforts undertaken by TBTF firms to reduce complexity, Richard Fisher, President of the Federal Reserve Bank of Dallas, in a statement to the U.S. House of Representatives, asserted that these institutions are still too complex and impervious for the living will to have any effect on the resolution of a failed firm.¹²⁰ This contention has some merit because the arrangement of legal entities can complicate bankruptcy proceedings considerably.¹²¹ Clearly, Lehman

115. Jonathan Macey, *Are Any Creditors "Particularly Deserving"?: On the Enduring Attraction of the Ring-Fence Approach to Cross-Border Insolvencies of Fin. Institutions*, 31 *YALE J. ON REG.* 695, 709 (2014).

116. Press Release, Elizabeth Warren, U.S. Senator, Donnelly, Warren Encourage Fed, FDIC to Consider All Statutory Tools if Banks' Living Wills Are Found Not Credible (June 20, 2016), https://www.warren.senate.gov/?p=press_release&id=1162.

117. CITIGROUP INC., OCTOBER SUBMISSION PUBLIC SECTION 22 (2016), <https://www.federalreserve.gov/bankinfo/reg/resolution-plans/citigroup-1g-20161001.pdf> (detailing efforts undertaken by Citigroup to streamline its organization).

118. *See id.* at 22 (listing non-core business lines that were sold, including one consumer lending company, resulting in a 70% reduction in non-core assets).

119. *Id.*

120. *See* Richard W. Fisher, President, Fed. Reserve Bank of Dallas, Statement before the Comm. on Fin. Servs.: Correcting 'Dodd-Frank' to Actually End 'Too Big to Fail' 9 (June 26, 2013), <https://www.dallasfed.org/news/speeches/fisher/2013/fs130626.aspx> ("Given the complexity and opacity of the TBTF institutions and the ability to move assets and liabilities across subsidiaries and affiliates . . . a living will would likely be ineffective when it really mattered.").

121. *See* U.S. GOV'T ACCOUNTABILITY OFF., GAO-11-707, BANKRUPTCY: COMPLEX FINANCIAL INSTITUTIONS AND INTERNATIONAL COORDINATION POSE CHALLENGES 28 (2011), <http://www.gao.gov/new.items/d11707.pdf> (reporting that complex institutions are difficult to resolve through bankruptcy proceedings in part because of their incongruent legal structures).

expanded its organization with little regard for how legal entities could be resolved in the event of bankruptcy.¹²² In most instances, the legal entities did not align with the operational structure of the company, making it difficult to map interconnections among subsidiaries.¹²³ Many core business lines were scattered across multiple subsidiaries because of the haphazard structure of material entities.¹²⁴ Consequently, as each subsidiary was sold to a new owner, the company lost access to information necessary to appraise and liquidate assets.¹²⁵

In a situation like Lehman's, where the corporate structure was already in disarray when it failed, a living will may not have any discernible effect on the resolution process.¹²⁶ However, achieving credibility under the living will requirement mandates that the banks engage in LER by identifying a resolution strategy and reorganizing their organization to coincide with that strategy.¹²⁷ Therefore, in the event that a covered company does fail, the living will shall provide a map of the organization's material entities, core business lines, and critical operations, as well as a separability strategy to enable rapid liquidation of assets.¹²⁸ Further, the information in the living wills provides the Agencies with ongoing insight into the unique operations of each firm and enables them to disseminate targeted feedback to improve resolvability.¹²⁹

B. *LER Addresses Financial and Operational Complexity*

When the parent holding company of an organization becomes

122. Richard Herring & Jacopo Carmassi, *The Corporate Structure of International Financial Conglomerates: Complexity and its Implications for Safety and Soundness*, in THE OXFORD HANDBOOK OF BANKING 196, 225 (Allen N. Berger et al. eds., 2012).

123. Stephen J. Lubben & Sara Pei Woo, *Reconceptualizing Lehman*, 49 TEX. INT'L L.J. 297, 303–04 (2014).

124. GAO-16-341, *supra* note 3, at 38.

125. GAO-16-341, *supra* note 3, at 38.

126. MICHAEL FLEMING & ASANI SARKAR, THE FAILURE RESOLUTION OF LEHMAN BROTHERS 188 (2014), <https://www.newyorkfed.org/medialibrary/media/research/epr/2014/1412flem.pdf> (highlighting the delays caused by the organizational complexity of Lehman which made it difficult to identify which Lehman subsidiaries creditors had claims against).

127. GUIDANCE 2017, *supra* note 28, at 10.

128. GUIDANCE 2017, *supra* note 28, at 19.

129. See JARQUE & PRICE, *supra* note 55, at 6 (concluding that increased understanding of the characteristics of each individual firm is one way to reduce the risk of future bailouts).

financially and operationally interconnected with its material entities, separating the failing holding company from its solvent subsidiaries for resolution becomes difficult.¹³⁰ For example, Lehman's parent company, Lehman Brothers Holdings, functioned by lending operating funds to its subsidiaries at the start of each day and collecting the cash at the end of each day.¹³¹ On September 15, 2008, Lehman filed for bankruptcy before funding its material entities, tying much of its cash up in bankruptcy and preventing its affiliates from sustaining critical operations.¹³²

To reduce financial and operational complexity that might otherwise obstruct an orderly resolution, the Fed adopted a final rule that requires large banks to adhere to a set of operating limitations called clean holding company requirements.¹³³ The clean holding company requirements limit the ability of parent holding companies to enter into certain financial arrangements with subsidiaries that may complicate resolution.¹³⁴ The regulation prohibits: (1) bank holding companies from acquiring third-party debt instruments with an original maturity of less than one year; (2) guaranteeing subsidiary debt if doing so would result in the holding company's insolvency; and (3) organizing upstream guarantees which occur when subsidiaries guarantee holding company debt.¹³⁵

The clean holding company requirements embody some of the goals of LER in that each restraint serves to reduce the operational complexity of a large financial institution and thereby prevent the contagion effects that exacerbated the financial crisis.¹³⁶ Requiring a minimum of one year for third-party debt instrument maturity mitigates

130. See Martin J. Gruenberg, Chairman, F.D.I.C., A Progress Report on the Resolution of Systemically Important Financial Institutions (May 12, 2015), <https://www.fdic.gov/news/news/speeches/spmay1215.html> ("The inability to resolve one legal entity without causing knock-on effects that may propel the failure of other legal entities within the firm makes the orderly resolution . . . extremely problematic.").

131. Herring & Carmassi, *supra* note 122, at 225.

132. Herring & Carmassi, *supra* note 122, at 225.

133. Press Release, Bd. of Governors of the Fed. Reserve Sys., TLAC and Clean Holding Company Requirements Finalized (Dec. 15, 2016) <https://www.federalreserve.gov/newsevents/press/bcreg/20161215a.htm>.

134. SIZE AND COMPLEXITY, *supra* note 17, at 25.

135. Total Loss-Absorbing Capacity, Long-Term Debt, and Clean Holding Company Requirements, 80 Fed. Reg. 74926, 74944 (Nov. 30, 2015) (to be codified at 12 C.F.R. pt. 217 and 252).

136. *Id.*

risks of funding runs, asset fire sales, and runs on other large financial institutions.¹³⁷ By limiting upstream guarantees, the holding company will be allowed to fail while its solvent subsidiaries continue to operate, ensuring continuity of shared services through resolution.¹³⁸ Finally, limiting the activity of the bank holding company creates a simplified legal and operational structure which supports orderly resolution.¹³⁹

While striving to satisfy the LER requirement and the clean holding company requirements, covered companies have simplified their operations from the top-tier holding company downward.¹⁴⁰ Overall, the firms have substantially reduced their total number of entities and restructured their organizations.¹⁴¹ For example, Bank of New York Mellon is in the process of moving its Indian subsidiary under its main bank;¹⁴² Goldman Sachs separated its operating entities from its investing entities;¹⁴³ and Morgan Stanley separated its investment management business from its institutional broker-dealer.¹⁴⁴ Further, all eight of the nation's largest banks are operating in accordance with the clean holding company rule, even though compliance is not due until January 2019.¹⁴⁵ This demonstrates that the banks are making strides toward addressing the complexity inherent in TBTF institutions.¹⁴⁶ Going forward, the Fed should refrain from imposing more prudential requirements on the banks.

IV. STRINGENT PRUDENTIAL REQUIREMENTS SHOULD NOT BE IMPOSED

A. *Prudential Requirements Generally*

While the nation's complex financial institutions have become larger since the crisis, the living wills process has made them less

137. *Id.*

138. *Id.*

139. *Id.*

140. *See, e.g.*, MS 2016 Letter, *supra* note 80, at 5 (noting the adjustments made in ownership structure).

141. Citigroup 2016 Letter, *supra* note 81, at 4.

142. BNYM 2016 Letter, *supra* note 16, at 5.

143. GS 2016 Letter, *supra* note 54, at 5.

144. MS 2016 Letter, *supra* note 80, at 5.

145. BNYM 2015 Letter, *supra* note 16, at 10.

146. INTERCONNECTEDNESS AND CONTAGION, *supra* note 18, at 238.

vulnerable to financial distress.¹⁴⁷ Further, each living will review cycle has provided information that is being used to mitigate obstacles to an orderly resolution in the event of financial distress.¹⁴⁸ Despite this, many are calling for the Fed to impose more stringent prudential requirements¹⁴⁹ on banks that fail to resolve deficiencies in their plans in the next submission cycle.¹⁵⁰ Though the threat of stricter prudential restraints provides a strong incentive for banks to comply with the living will requirement, the enforcement of any one of these measures could have negative impacts that extend beyond the covered company's operations.¹⁵¹

The Fed and the FDIC set out the process used to impose additional prudential standards when a covered company fails to submit a credible living will.¹⁵² First, if a covered company submits a plan that is deemed deficient by the Agencies, that company has ninety days to resubmit an updated plan that adequately addresses the deficiencies.¹⁵³ Next, if the Agencies jointly determine that the revisions do not remedy the deficiencies, then the covered company or any of its subsidiaries may be subjected to "more stringent capital, leverage, or liquidity requirements or restrictions on growth, activities, or operations."¹⁵⁴

Finally, if after two years the covered company still has not submitted a credible plan, the Agencies may direct the company to divest certain assets or operations.¹⁵⁵ This illustrates the powerful tools

147. SIZE AND COMPLEXITY, *supra* note 17, at 13 ("While large bank holding companies have become larger, they are less vulnerable to financial distress since the enactment of the Dodd-Frank Act.").

148. 80 Fed. Reg. 74926, 74928 (Nov. 1, 2015) (to be codified at 12 C.F.R. pt. 217 and 252).

149. This note focuses on strict prudential standards that may be imposed as a result of deficiencies in living wills. *See* Failure to Cure Deficiencies on Resubmission of a Resolution Plan, 12 C.F.R. 243.6 (2016). However, U.S. banks are already subject to enhanced prudential standards including mandatory capital planning, periodic stress testing, and establishment of risk management standards. *See* Press release, Bd. of Governors of the Fed. Reserve Sys., Final Rule to Strengthen Supervision and Regulation of Large Bank Holding Companies (Feb. 14, 2014), <https://www.federalreserve.gov/newsevents/press/bcreg/20140218a.htm>.

150. Warren Press Release, *supra* note 13.

151. *See e.g.*, Sarin & Summers, *supra* note 19 (manuscript at 15) (discussing the corresponding relationship between increased capital requirements and increased market volatility).

152. Resolution Plans, 12 C.F.R. § 243.6.

153. *Id.*

154. *Id.*

155. *Id.*

that the Fed has at its disposal to intervene when it is appropriate to do so. However, the use of any one of these tools could impact market volatility and the economy.¹⁵⁶ Therefore, regulators should only use additional prudential requirements when the benefits of imposing the restrictions outweigh the costs to market stability.

B. Impacts of Restrictions on Capital, Leverage, and Liquidity Limits

Capital, leverage, and liquidity measures are indicators of the health of a financial institution and can be used to increase the safety and soundness of that institution.¹⁵⁷ Likewise, maintaining optimal capital and liquidity while carefully monitoring leverage will help banks weather financial crises.¹⁵⁸ Because of this, regulators carefully supervise these metrics and take enforcement actions when these measures indicate that the bank is at risk for insolvency.¹⁵⁹ Early corrective action could prevent bank failure and thus prevent harm to the market.¹⁶⁰

Despite these advantages, regulatory action such as stringent capital and liquidity minimums against a solvent bank increases market volatility.¹⁶¹ For example, excessive capital requirements could decrease investor confidence in the soundness of the bank and thereby lower the franchise value of that institution.¹⁶² This is because

156. See e.g., Sarin & Summers, *supra* note 19 (manuscript at 27) (suggesting that market volatility may have increased because of greater regulatory uncertainty).

157. See e.g., CITIGROUP, CITIGROUP INC. RESOLUTION PLAN PUBLIC SECTION, 15 (July 1, 2015), <https://www.federalreserve.gov/bankinforeg/resolution-plans/citigroup-1g-20150701.pdf> (detailing actions taken to maintain capital and liquidity levels vital to the successful execution of resolution strategy).

158. SR 14-8, *supra* note 27, at 3.

159. SR 14-8, *supra* note 27, at 3.

160. SR 14-8, *supra* note 27, at 3.

161. See Sarin & Summers, *supra* note 19, (manuscript at 34). In this report, Natasha Sarin of the Harvard University Department of Economics and Lawrence Summer of the JFK School of Government at Harvard conclude that the franchise value of banks, measured by the ratio of price to book value and the ratio of the market value of equity to assets, has declined since the financial crisis. The report asserts that “part of the reason for declines in franchise value is regulatory activity and the prospect of future regulation” and that “[t]here is a possibility that by further eroding bank franchise value, further regulatory actions could actually increase systemic risk.”

162. See INTERCONNECTEDNESS AND CONTAGION, *supra* note 18, at 110 (explaining how government policy during the 2008 crisis exacerbated the financial crisis because concern about the health of the banks increased after the announcement of the TARP program).

government intervention causes concerns about the health of large financial institutions.¹⁶³ Further, increased capital requirements would require the bank to forego investments that would yield profit for their investors and benefit the market.¹⁶⁴ Not surprisingly, economists have observed that “a large part of the reason for declines in franchise value is regulatory activity and the prospect of future regulation.”¹⁶⁵

C. Impacts of Restrictions on Growth, Activities, Operations

It makes sense to limit the growth of an institution that is considered TBTF, because many regard size as the most significant risk associated with banks.¹⁶⁶ One of the concerns is that a bank that is TBTF will be too large to be sold in the event of financial distress.¹⁶⁷ However, the enforcement of growth limitations would impair significant benefits that large banking firms provide to the market: the economies of scale that they possess due to their size, and their ability to diversify risks.¹⁶⁸

Banks achieve economies of scale when output can be doubled for less than a doubling of cost.¹⁶⁹ If these cost savings are jeopardized by regulatory limitations on growth, market participants will pay for it through higher costs for products and services that banks provide.¹⁷⁰ Further, research shows that size does not have as significant an impact on bank safety as much as regulatory supervision which ensures continued inspection of bank risk taking.¹⁷¹ Accordingly, the living wills process has become an excellent tool for regulatory supervision because it provides updated reports containing full disclosure of covered companies’ overall operations.¹⁷²

163. INTERCONNECTEDNESS AND CONTAGION, *supra* note 18, at 110.

164. See Pakin, *supra* note 112, at 61 (explaining how increased capital requirements reduces the funds available to borrow for investments).

165. Sarin & Summers, *supra* note 19, (manuscript at 34).

166. JARQUE & PRICE, *supra* note 59, at 3.

167. See Pakin, *supra* note 112, at 91 (asserting that no single entity could purchase a failing systemically important financial institution without government support).

168. SIZE AND COMPLEXITY, *supra* note 17, at 9.

169. SIZE AND COMPLEXITY, *supra* note 17, at 9.

170. SIZE AND COMPLEXITY, *supra* note 17, at 9.

171. SIZE AND COMPLEXITY, *supra* note 17, at 13.

172. See SIZE AND COMPLEXITY, *supra* note 17, at 24 (stating that regulators are using the living wills mandated by Dodd-Frank to gain understanding of the workings of large financial institutions).

The most severe of the prudential requirements would require a bank to divest assets chosen by the Fed in its discretion.¹⁷³ While directing a financial institution to divest a business line may reduce the risk of harm to the economy arising from that company's failure, limiting activities could constrain the institution's ability to reduce the risk of insolvency by diversifying its business lines.¹⁷⁴ Large banks have the unique capability to diversify risks by investing in nontraditional banking activities, which has been shown to decrease the risk of contagion.¹⁷⁵ Nonetheless, diversification contributes to complexity which increases the chances of complications during resolution.¹⁷⁶ To address this risk, covered companies must design living wills that apply LER criteria to each new entity and line of business to ensure that resolution procedures are at the forefront of considerations related to diversifying activities.¹⁷⁷ Therefore, it is more advantageous to refrain from restricting activities until a covered company has had adequate time to restructure its activities according to the LER criteria.¹⁷⁸

Limiting the growth of a bank is one way to address the risk that, in the event of a failure, the government would be the only entity available to purchase remaining assets and bail out the bank.¹⁷⁹ However, LER requires material entities to correspond with business lines so that they can be sold in separate, affordable pieces apart from

173. Failure to Cure Deficiencies on Resubmission of a Resolution Plan, 12 C.F.R. 243.6 (2016).

174. See SIZE AND COMPLEXITY, *supra* note 17, at 22 ("The larger the bank, the smaller the marginal increase in contagion risk due to diversification into nontraditional banking activities, as measured by the noninterest income share.").

175. See SIZE AND COMPLEXITY, *supra* note 17, at 22.

176. See SIZE AND COMPLEXITY, *supra* note 17, at 26 ("To the extent diversification leads to greater organizational complexity, that itself can present additional risks given the increased difficulties with resolving complex institutions.").

177. See SIZE AND COMPLEXITY, *supra* note 17, at 28 (explaining that the living will for a company must identify operational interconnection to facilitate rapid transfers or sales of legal entities or business lines).

178. DELOITTE, TACKLING TOO-BIG-TO-FAIL: THE RESOLVABILITY CHALLENGE FOR BANKS 22 (2016) <https://www2.deloitte.com/content/dam/Deloitte/uk/Documents/financial-services/deloitte-uk-too-big-to-fail.pdf>.

179. See Mehrsa Baradaran, *Regulation by Hypothetical*, 67 VAND. L. REV. 1247, 1312 (2014) (quoting Jim Millstein, former Chief Restricting Officer of the Treasury Department who stated: "[t]here are few if any institutions with the balance sheet to support the purchase of one of these businesses in good times . . . there is no credible way to break [these firms] up and sell them during a crisis").

the bank holding company.¹⁸⁰ Requiring covered companies to develop plans to recapitalize individual entities and detail steps to continue critical operations while each is being sold will aid in the successful transfer of these material entities.¹⁸¹ Therefore, the living will requirement serves as a tailored tool to distribute bank assets without restricting growth.

The Agencies require each covered firm to identify triggers that signal commencement of resolution activities, such as the escalation of information to the company's board and the raising of capital or liquidity before a crisis starts.¹⁸² While Lehman was unequipped to manage the resolution of its global enterprise during the financial crisis, firms that plan responses to a variety of scenarios will be armed with necessary information to make better choices regardless of their size.¹⁸³ The living will's LER requirement is effective in this regard because it facilitates advance preparation for financial crises by requiring firms to plan specific actions in response to a variety of scenarios for each material entity, including a separability analysis.¹⁸⁴

Due to the potential impacts on the financial markets and the effectiveness of the living will process, the Agencies should only restrict bank activities when doing so is absolutely necessary. Strict prudential requirements should only be forced upon institutions that resist resolution planning and implementation because, as discussed, such regulatory action could be costly to the health of the economy. On the other hand, firms—like Wells Fargo—that are working diligently and that invest resources to create a credible living will should be allowed to improve without having additional restraints placed on their business activities.

V. CONCLUSION

The living will process was designed to be iterative in order to facilitate the supervisory goals of the regulation.¹⁸⁵ As projected by

180. GUIDANCE 2017, *supra* note 28.

181. DELOITTE, *supra* note 10, at 4.

182. JP Morgan 2016 Letter, *supra* note 63, at 15.

183. See Pakin, *supra* note 112, at 43 (stating that “preparing recovery plans forces SIFIs to consider in advance some tough strategic choices”).

184. GUIDANCE 2017, *supra* note 28.

185. See Resolution Plans Required, 76 Fed. Reg. 67323, 67328 (Nov. 1, 2011)

various scholars when the living will requirement was newly enacted, the covered companies subject to the regulation have improved their daily operations, organizational structure, and information systems as a result of the planning process.¹⁸⁶ The regulation has been in effect for five short years, and the Agencies emphasized that significant changes would have to be made before a complex firm could go bankrupt without major disruptions to the financial system.¹⁸⁷

The living wills requirement has facilitated a back and forth dialogue that allows the Agencies to guide banks' progress on an individual level.¹⁸⁸ The feedback from the Agencies guides the covered companies in their endeavors to reshape their organization to reduce the likelihood that the government will need to assist the firms during resolution.¹⁸⁹ However, the process is new and both the Agencies and the banks are evolving.¹⁹⁰ Further, the banks must invest in sophisticated and costly research and development to meet the standards set by the Agencies.¹⁹¹ While stringent prudential requirements may be in order for banks that willfully refuse to adhere to the living will guidance issued by the Agencies, it is counterproductive to penalize covered companies, like Wells Fargo, for failing to meet standards that they are striving to satisfy.¹⁹²

Some commentators believe that the living wills requirement is ineffective because the nation's largest banks are still TBTF.¹⁹³ However, the covered companies have taken many steps to comply with the LER requirement which has led to a reduction in complexity and an increase in streamlined operations in these organizations.¹⁹⁴ The living

(codified at 12 C.F.R. § 243) (clarifying that the Agencies "expect the process of submission and review of the initial resolution plan iterations to include an ongoing dialogue with firms").

186. See Pakin, *supra* note 112, at 62 ("[B]y preparing living wills, SIFIs will improve their risk management systems, as well as their day-to-day operations . . .").

187. Baradaran, *supra* note 179, at 1313.

188. JARQUE & PRICE *supra* note 55, at 9.

189. JARQUE & PRICE *supra* note 55, at 11.

190. See JARQUE & PRICE *supra* note 55, at 9 ("It's new and difficult terrain for both institutions and regulators.").

191. DELOITTE, *supra* note 178, at 22.

192. See Pakin, *supra* note 112, at 74 (endorsing the idea that severe punishment as described in the Dodd-Frank Act should be inflicted upon those who deviate from the rules).

193. R. STAFF OF H. COMM. ON FIN. SERVS., 113TH CONG., FAILING TO END "TOO BIG TO FAIL" 67 (Comm. Print 2014).

194. BNYM 2016 Letter, *supra* note 16, at 5; see also WF 2016 Letter, *supra* note 67, at

will requirement is, through an iterative process, making the nation's largest banks simplify their structures to enable separability of entities in the event of resolution.¹⁹⁵ Thus, the living will process has enabled the banks and the Agencies to address the complexity associated with resolving a TBTF firm.¹⁹⁶ The evidence of the effectiveness of the living will process as it stands counsels against the imposition of more stringent prudential requirements on the banks.

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5 (noting that Wells Fargo has reduced its number of entities since purchasing Wachovia).

195. JARQUE & PRICE, *supra* note 55, at 15.

196. Michael Corkery, *Wells Fargo 'Living Will' Plan Is Rejected Again by Regulators*, N.Y. TIMES (Dec. 13, 2016), <http://www.nytimes.com/2016/12/13/business/dealbook/wells-fargo-regulators.html> ("Of all the rules passed in the wake of the crisis, this requirement is designed to address most directly the issue of big banks' being too big to fail.").

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