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Five Major U.S. Banks' Living Wills Fail to Pass Regulatory Muster

By Myriam Denis, J.D. Candidate 2016 | April 18, 2016

On April 13, 2016, the Federal Reserve and the Federal Deposit Insurance Corporation (FDIC) jointly announced that five major banks – JPMorgan Chase, Bank of America, State Street, Wells Fargo and Bank of New York Mellow – failed to fulfill an important regulatory requirement of the Dodd-Frank Act, the major piece of legislation introduced in 2010 by Congress following the 2008 debacle. The "living wills" provision of the Dodd-Frank Act demands that big banks provide regulators with carefully drafted plans for how they would deal with a potential bankruptcy. This ambitious section seeks to make it easier for bank regulators to oversee potential bankruptcies by providing an orderly method to avoid the kind of chaos that followed the Lehman Brothers' bankruptcy. The current process requires banks to submit updated living wills every year. Whether living wills pass muster critically hinges on whether they are "credible."

Both the Federal Reserve and the FDIC found that the five banks' plans were "not credible" or "would not facilitate an orderly resolution" under the U.S. Bankruptcy Code. According to the regulators, JPMorgan did not have sufficient models for estimating how it would keep money flowing to sustain its operations during a bankruptcy resolution. The Bank of America plan failed with regards to its plan for winding down its portfolio of derivatives. The vice chairman of the FDIC, Thomas M. Hoenig, was very critical, saying "No firm yet shows itself capable of being resolved in an orderly fashion through bankruptcy."

Some other banks that recently submitted plans also did not past regulatory muster, but unlike the five giants mentioned in the preceding paragraphs, they failed to pass either FDIC or Federal Reserve muster, but not both. For instance, the FDIC determined that Goldman Sachs' plan was not credible, but the Fed did not agree. Citigroup, another major bank, was the only one that succeeded in submitting a plan that mostly satisfied both regulators.

The rejection of the living wills is a blow to the management of the five concerned banks, especially since some of their peers were able to get the approval of at least the Federal Reserve or the FDIC, or in Citigroup's case, both. The banks had months to prepare and present their living wills, and regulators gave responses to previous plans, specifically pointing out perceived shortcomings. A few years ago, the senior managers of the banks might have been able to argue to their boards that those living wills were a new requirement and that feedback from regulators was lacking, but not this time. However, they might be able to argue that even though Dodd-Frank was enacted into law more than five years ago, the Fed and FDIC still haven't agreed on and defined what "credible" exactly means in the living wills context. They might also reasonably argue that it's slightly odd that there are two different regulators in charge of the living wills requirement and that the fact that some banks pass muster at one regulator while failing the at the other adds to the existing confusion. More fundamentally, some experts argue that running an efficient business profoundly conflicts with strictly planning for the need to prepare an orderly failure.

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The five banks have until October 1, 2016 to fix their plans. Afterwards, if the two regulatory organizations are still dissatisfied with the living wills, they can impose restrictions on the banks' activities or make them raise their capital levels. If after two years the regulators think the plans are still deficient, they can require the banks to sell off assets and businesses. These measures are quite drastic and would substantially impact the financial operations of concerned banks. For this reason, analysts are worried about the potential severe impact on markets of a negative ruling on a bank's living will. A few weeks ago, Jaret Seiberg, analyst with Guggenheim Securities, stated "an adverse ruling on a living will would catch the market off guard."

The Dodd-Frank Act and the wider too-big-to-fail issue has been an important topic in the current presidential race. Partisans of Dodd-Frank will most likely use this episode as proof that most major banks are still too big to fail and continue to pose an unsustainable risk to the economy.