ARE LIVING WILLS THE ANSWER?

The Risk Universe columnist Annie Searle addresses the issue of "living will" compliance for financial institutions

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The first and second waves of "living will" compliance for banks and depository institutions with consolidated assets of more than $50 billion has elicited a fair amount of scepticism with a few dashes of scorn. Because of the liability around preparing such documents for the regulators in aid of the Dodd-Frank Act (DFA) Rule and the Insured Depository Institution Rule (DI Rule), the documents are generally prepared by lawyers rather than business leaders or the board of directors of an institution. It's not just American banks that must comply: foreign banks that have US branches as well as any nonbank financial company designated as "a systematically significant financial institution (SSFI)" must also submit a living will.

In your personal life, creating such a document is relatively easy if you are a thoughtful person: you identify the person who can make medical decisions for you if you are incapacitated; and you specify with the some degree of clarity just what measures you wish taken to keep you alive under certain conditions. The intent behind the DFA/DI rulemaking is that the measures to be taken will not keep you alive. Rather, they will save the regulators and the courts the burden of figuring out where to sell off the assets to avert any cost to the financial system or its taxpayers. That is the assumption, at least. From FDIC Board minutes in September of 2011, we see that there is a determination by the FDIC to get out from under funding critical operations during such a resolution process, and "to facilitate improved efficiencies and risk management practices amongst systemically important financial institutions as they produce and evaluate these plans."

For a financial institution, however, to specify where its assets might be sold expeditiously is only a small part of what is required by the DFI and DI Rules. A bank's living will must take into account insolvency law, change of control provisions, tax and corporate law. This is good news for law firms who will end up preparing such documents. "They are an exercise while things are fine, prepared by lawyers and not representative of what might happen," said Mark Williams, a former Federal Reserve bank examiner and a professor of finance at Boston University." [New York Times, July 3, 2012]

Creation of the living wills is an expensive proposition, an outgrowth of the 2008 financial collapse. They satisfy a regulatory requirement that is unlikely to change over the next decade. But will preparing these living wills be sufficient to avert losses that seem inevitable as a result of the interconnectedness of such large and complex institutions? Given that the living will be with us for some years, what could banks be doing internally to ensure the viability of their institutions the next time we experience such a downturn – that is, to survive rather than to be taken apart?

I cut my operational risk teeth in the field of business continuity planning, in which most scenarios imagined posit significant financial loss during short-term setbacks like data center outages, hacked websites, hurricanes, wildfires, floods, tornadoes or earthquakes. The question that is asked first of any critical business process is: "What if it was not available for one hour/two hours/four hours/eight hours/24 hours/48 hours? How long could you live without it?" In order to answer that question, one has to trace the interdependencies between a critical business process, its technology platform(s) and third party vendors, and its relationship to other business being done by the institution. Answers to these questions and others that are part of a Business Impact Analysis (BIA) represent for me the foundation of an operational risk framework, particularly when one includes the scenario tests that are a part of a world class continuity planning program.

In answering the key questions to produce a living will, the lawyers will almost certainly reference an institution's business continuity plan, often the only inventory of its core business lines and critical operations and functions. It seems likely that existing contingency planning programs will evolve to stay in synch with the living will document and should begin to test broader economic scenarios that are already a part of the Basel program. Other than the living will and business contingency planning programs, where else might executives and regulators look to shore up the resiliency of an institution?

I recommend that both boards of directors and regulators look closely at the strength of an executive succession planning program. While implemented well at middle and senior management levels in many banks, it appears to be unsuccessful or nonexistent at executive levels. It is still a very delicate matter for boards of directors to insist that a Chief Executive Officer identify and develop potential successors. The banking and insurance industry is known for nearly Shakespearean twists and turns in this area. Tracing a single example might look like this: Jamie Dimon was at one time the heir apparent to Sanford Weil at Citigroup. When he left Citigroup, he went on to make a larger and more complex bank from the merger of Bank One and JPMorgan. Over the years, JPMorgan Chase has had any number of senior executive understood to be on the "successor track" but who have given up and left the bank. Dimon is sitting in the catbird seat still: he enjoys the dual titles of chairman and CEO still. Before the last annual board meeting, the media reported that he told the board he would leave the bank if the chairman title were removed; and that appeared to be sufficient warning for large investors to vote that he retain both titles. Does the "living will" requirement take situations such as this into account? Who will compel Dimon to put a genuine succession program into action? Looking past JPMorgan Chase to other large banks, how many have succession plans in place against scenarios that include a CEO dying, or perhaps injured and out of the office for up to six months?

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Both contingency planning and succession planning can be considered as tools to enhance living wills. Rather than focus on winding down a large and complex institution, they offer forward looking and practical opportunities for sustained growth and profitability.

Starting with the Lehman Brothers failure on September 15, 2008, a total of $16.7 billion in deposits was removed over a ten day period from Washington Mutual, which led to the FDIC seizure and sale to JPMorgan Chase. That seizure cost depositors nothing because of the way the FDIC structured the deal. Would a living will or a scenario test have saved the bank? I have my doubts. The seizure happened without advance warning. The bank lacked an internal successor to the former Chairman/CEO, and was rife with misplaced confidence from the board that it was making its case effectively in Washington DC. Not even a living will plan would have been sufficient to dampen the view that things were turning around, that there was no need to pull the plug. In short, a living will is no substitute for hubris. Can we honestly say that would not still be the case if a large bank ran into rather similar trouble today? TRU