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TBTF and the Futility of the Living Will

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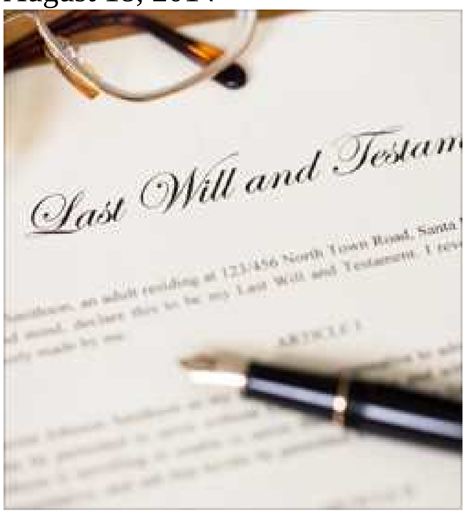

How did we get to a point where we are asking our biggest financial institutions to contemplate their deaths? Wasn't the idea of a corporate charter to allow an institution to exist in perpetuity?

The baseline in securing our financial system from failure is to have its biggest actors set aside more capital. Since our largest financial institutions during the financial crisis blew through their capital in record time our regulators concluded more capital was better than less. That is true, but setting aside more capital only sets a higher water mark for counting down to failure. Nothing much of substance has been done to affect permanent change so that we do not approach another financial Armageddon.

How do regulators, obligated to oversee the financial system, get their arms around financial behemoths whose sheer number of legal entities clouds understanding of these subsidiaries' individual risks (let alone their contribution to the risk of the enterprise overall)? To understand the risks that systemically important financial institutions present to the financial system, regulators must first understand their interdependences internally within their own corporate structure, then externally, across multiple financial institutions.

The public resolution plan filings dated July 1, 2014, include a section on Material Entities. The largest SIFIs list 15 to 30 material entities each. However, these same SIFIs listed thousands of legal entities. As examples, Citigroup has 1,817 legal entities, Goldman Sachs has 14, 527, JPMorgan Chase has 4,376 and Morgan Stanley 8,825.

Similarly, the Material Management Information Systems section for these four SIFIs describes either a near-nirvana of interrelated smoothly functioning systems; an in-process aspirational expectation for systems improvement; or a high level functional description of what smoothly functioning management information systems are *intended* to do. These descriptions belie an unfathomable Rube Goldberg infrastructure of interconnected accounting, risk, business process and performance management systems, built up over decades of mergers and acquisitions.

When we couple the organizational complexity of thousands of legal entities with the underlying complexity of generations of legacy systems we can begin to understand the enormity of the task of dismantling global financial conglomerates.

We need something more substantial than the living wills that regulators have, understandably, found wanting.

A living will requires the drafter to a have a full and granular inventory of assets, liabilities, systems and interconnections as well as exposure to all outside counterparties, clients, facilities and organizations. If CEOs aren't themselves informed of all the pieces that have evolved over nearly a half century of financial conglomeration, how will they inform regulators?

We need to allow these financial conglomerates the opportunity and incentives to reengineer themselves so that they can be understood and become transparent to regulators.

The too-big-to-fail business model proved faulty, not because it was wrong to be big, global and diversified — that is where their global clients were going. It proved faulty because the blueprints for these financial behemoths were missing. The revenue was pouring in faster than systems could be rebuilt. Revenue won out over pausing to rebuild. Incentive compensation packages won out over investing in infrastructure.

How can regulators, guided by a hastily prepared living will, dismantle or recover these giants from serious capital depletion or failure? We will surely pull the wrong brick or tug the wrong pipe and topple the whole edifice.

Best to place society's bet on a reengineering plan, a positive reinforcing strategy that at its end point creates a transparent and efficient financial institution within a globally risk-adjusted financial system. Regulators' computers, tied into the rebuilt institutions, can monitor transactions in real-time and see risk building up.

Reengineering financial institutions is made more doable, now that the Group of 20 major economies, through the Financial Stability Board, has been overseeing a long-missing global identification system for financial market participants and the products they own, trade and process. It is amazing that the industry and its regulators survived without such a means to aggregate and view financial transactions electronically. It is also amazing that this transformational global identification system is not even on the radar screen of CEOs who run these SIFIs.

With such a foundational infrastructure element being put in place and an awakened regulatory community aware now of the impracticality of relying on living wills to prevent another systemic contagion, it's best to find an alternative.

Offer regulatory incentives to design reengineering plans that inspire a bright future rather than living wills that contemplate one's death. It will then become a priority for SIFI CEOs.

Allan D. Grody, the president of Financial InterGroup Holdings Ltd., is a 50-year veteran of the financial industry. His work and writings focus on the intersection of risk, data and technology. He is writing a book, "Reengineering Financial Institutions."