Buried within the 88-page Obama administration proposal to overhaul financial regulation is an overlooked option called a “rapid resolution plan”. It mandates that systemically important financial companies be required regularly to file a “funeral plan”: a set of instructions for how the institution could be quickly dismantled should the need to do so arise. This simple step would have both short-run benefits if another wave of panic occurs and longer-term pay-offs that would complement other reform efforts. It could be implemented now, without the need for legislative action. Regulators should do so immediately.

The first benefit is that regulators would gain a stronger negotiating position with a dying institution. Throughout this crisis the authorities have had to intervene without knowing exactly what hidden traps might emerge if a bank were to be closed down. The bankers know this and can exploit the fear of the unknown to press for bail-outs.

It is remarkable that such rules do not already exist. The hideously complex Basel II regulatory rules already force banks to describe other types of operational risk; for example, since September 11 2001 many businesses have invested heavily in planning for terrorist attacks. The crisis has shown us that the sudden unwinding of a large, complex financial institution is terrifying for the financial system.

The current arrangements are akin to forcing the Pentagon to go to war without ever having been able to simulate a war game. The disclosures contained in the rapid resolution plans would make this type of planning possible. While war games are far from perfect, knowing that some had been conducted might make all market participants more willing to tolerate a failure.

A second immediate benefit would be to force bank managers to think much more carefully about the complex financial structures they have created. If bankers had to explain every single step needed (and the associated consequences) to shut down their subsidiaries in all the various jurisdictions in which they operate, they would have a big incentive to simplify their organisations.

The filings might well uncover other legal nightmares. During this crisis we have found that certain contractual obligations (such as the vast web of credit default swaps) placed substantial constraints on the choices facing regulators. It is unlikely that we have discovered all of these hidden restrictions, so why not force the banks to start figuring them out?

Over the medium term, there would be additional benefits. The headline component of the plan would be the requirement for banks to estimate the number of days it would take to shut down. Banks that require longer to close would have to hold more capital. This would place management under serious pressure to improve their plans, which would be disclosed in quarterly shareholder filings.

Senior members of the management team and the board would have to understand the funeral plan. Crucially, they would be forced to sign off on its accuracy. This might also lead to closer scrutiny of new products or lines of business if they jeopardised an orderly unwinding.

We would all have benefited if the largest financial firms had put better risk management systems in place. One obstacle is that within most institutions, power and authority are concentrated in the profit centres; risk management does not immediately contribute to profits. The introduction of a funeral plan would allow risk managers to make obvious contributions to profitability – because the better ones would free up capital.

Systemic regulators that are on the way to being created could also scrutinise the plans to keep up with market developments and predict new risks. This process would also provide regulators with a forum for questioning banks about the risks of their new products.

This proposal is far from a cure-all. One big problem is that resolution rules themselves, especially when multiple legal systems are involved, are quite complicated. But the plan has an extremely high benefit-to-cost ratio and could be put in place right away. Once in place it might also create additional pressure to work towards harmonising bankruptcy procedures, which the Obama proposal rightly identifies as an essential, but missing, tool.

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