Federal Financial Analytics, Inc.

MEMORANDUM

TO: Federal Financial Analytics Clients

FROM: Karen Petrou

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One can pretty much count on senior Democrats to demand summary execution when Wells Fargo stumbles on its troubled path to exoneration from the Fed's scorching 2018 enforcement order. So, when the OCC last week embarrassed the bank with renewed sanctions, Sen. Warren didn't miss a beat; as we noted, she promptly sent Jay Powell a letter demanding that the bank be disemboweled. However, if Sen. Warren really wants to ensure that accident-prone banks mend their ways, she would do better by pressing remedies that might really work for the consumers she wants to protect.

Disembowelment via Sen. Warren would come via regulatory resurrection of the Glass-Steagall Act along her preferred lines. As she explains this in her letter, the Fed would use the authority she believes it has to revoke Wells Fargo's charter as a financial holding company (FHC), thereby ending the holding company's ability to engage in both consumer banking and securities activities.

Sen. Warren considers the mix of consumer and capital-markets activities fraught with contagion for vulnerable consumers, but none of the violations that sparked enforcement orders has anything to do with wholesale finance and could well have occurred in the most consumer-pristine of retail banks. For example, the OCC's latest order punishes what are said to be severe lapses in mortgage servicing. IPO offerings, brokerage services, and even junk-bond sales have diddly to do with mortgage servicing or the cross-selling scandal that brought all this down on the bank in the first place. Thus, divesting capital-markets activities would have no beneficial impact on prospective consumer-finance compliance.

Indeed, it could even make it harder by choking off a revenue source necessary to rebuild compliance and control capacity. Failure to build these compliance-and-control systems are the problem, not activities outside their ken.

Sen. Warren's putative solution to an erring big bank isn't the only one which wouldn't accomplish its objectives. Where Sen. Warren favors evisceration, HFSC Chairwoman Waters instead has argued for amputation. Her 2017 "megabank" break-up bill doesn't draw arbitrary lines about which activities may be housed in a delinquent FHC; instead, it just demands that the company be cut into smaller pieces.

Would this do consumers any good? I doubt it. Many of the most pernicious predatory-finance practices come from relatively-small companies with no scruples. Scruples may not grow more easily on big companies, but sheer size is not an indicator of evil – just of potential market concentration, systemic risk, or other worries consumer-compliance violations are unlikely on their own to present.

Does this mean that giant miscreant banks should be left essentially as is? Of course not.

What would make a meaningful difference not just in nominal compliance, but also and more importantly to best practice is incentive alignment. This comes not from the vague, unenforceable codes of conduct regulators touted after 2008, but from hard-nosed, clear-eyed, strong-arm corporate governance and, when this fails, then from regulatory penalties that go straight to the top of the board and directly into the corner office.

Knowing that personal disgrace and significant income loss is immediately attendant on findings of severe consumer harm will offset the otherwise insatiable lures of quarter-over-quarter returns and the incentive comp that comes with them. It may be easier to say that heads should roll than to begin the beheading, but regulators need to wield the axe handed to them by law. Even just a few decapitated senior officers will prove a far better deterrent than complex enforcement orders, not-so-independent monitors, and the year-in, year-out billions spent on compliance remediation with little meaningful result.