Federal Financial Analytics, Inc.

MEMORANDUM

TO: Federal Financial Analytics Clients

FROM: Karen Petrou

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As we noted in a recent report, a divided Congress that may not even be able to keep the U.S. Government in business is one unlikely to enact substantive financial reform. Thus, we're in for yet another episode of political damage control, regulatory excuses, and a few heads on enforcement spikes without meaningful, measurable, and accountable supervisory reform. Been there, done that, had another financial crash, or so my dispiriting read of recent efforts to force post-crash supervisory reform makes all too clear. It's probably too much to ask that Congress not flit off to the next election before it ensures meaningful regulatory-agency accountability for manifold supervisory lapses, but if it does what it usually does, then we are doomed to more crashes with worse consequences unless it and the White House force the Fed to do what it's never done before: meaningfully and transparently improve supervisory rigor and enforcement might.

In my memo three weeks ago, I showed how regulators by 2001 had failed to act on the lessons of the 1980s and 1990s before the largest bank failure at the time presaged the great financial crisis hot on its heels. After the GFC, the U.S. convened the Financial Crisis Inquiry Commission (FCIC). When it issued its report in 2011, it drew scathing conclusions not only about all the "light-touch" regulation before the crash, but also supervisory unwillingness or inability to ensure that what rules there were were rules that were obeyed.

Despite this report and all the super-tough rules demanded by Dodd-Frank in 2010, there were worrisome signs by 2014 that big-bank supervisors and most especially those at the Fed were going back to the bad old days. Indeed, even when supervisors sought to intervene, the supervisory supervisors atop the regulatory agencies all too often overruled them.

This came to light most clearly in a case in which a Federal Reserve Bank of New York supervisor was first overruled and then fired. She didn't go quietly – tapes she made of her efforts first aired in national media and then a hearing in which the Reserve Bank's president, Bill Dudley, was hauled before a more than skeptical Senate Banking subcommittee.

In an eerie precursor of the Fed's response to SVB and other recent failures, the central bank issued a "self-review" the day before the hearing that the *New York Times* subsequently called "damage control." Also eerily, the then-chairman of the subcommittee, Sherrod Brown, said what HFSC Chairman McHenry is saying now – i.e., that the Fed's supervisory apparatus, such as it might have been, was grievously undermined by the absence of the confirmed vice chairman of supervision demanded four years before by the Dodd-Frank Act. Why this was is a matter of speculation, but much was said then about the Fed's unwillingness to give a tough-minded governor, Dan Tarullo, too much independent authority.

At the 2014 hearing, Mr. Dudley also defended the Fed's willingness to tolerate malfeasance as long as the Fed didn't think it was also illegal, a policy Sen. Brown said was proof the Fed tolerated "shady, but legal" banking. Mr. Dudley denied this, but evidence showed that the Fed only threw the book when the book was its own and clearly besmirched by violations within the narrow range on which it focused no matter how much of a mess might be found on other pages.

Case in point: Credit Suisse figures prominently in this sorry tale of Fed light-touch supervision. In 2014 as now, the Swiss bank was found to have egregiously enabled U.S. tax evasion. Mr. Dudley said that Fed supervisors did not consider this a concern because it didn't put the bank at risk. He was excoriated for this and Congress subsequently decided it couldn't trust the Fed, enacting punitive legislation governing Swiss banks. Even so, CS apparently went right on enabling tax evasion under the Fed's nose.

And, when Archegos blew up at so much cost to CS in 2021, the Fed's supervisory vice chair serenely told Senate Banking that what led CS astray was domiciled in Switzerland even though Archegos was just blocks away from the Federal Reserve Bank of New York. In short, see some evil, sanction some evil unless the evil is done only to those you know.

We know all too well from these and so many other retrospectives that financial regulation is only effective if supervision is a credible first line of defense as well as a sure and certain sword of retribution. We may well need some new rules and to revamp FDIC insurance, but we still more urgently need meaningful Congressional and White House demands for and then guarantees of radical supervisory reform mandated by transparent standards ensuring that this time is really different. Without far more accountability, more Fed promises are sure to lead only to more financial crises.