Federal Financial Analytics, Inc.

MEMORANDUM

TO: Federal Financial Analytics Clients

FROM: Karen Petrou

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Last week, a moderate Senate Democrat was joined by a Republican in yet another letter demanding an independent investigation of regulatory actions related to recent bank failures. But, as the absence of specifics in any of these letters makes clear, it's a lot easier to call for independent inquiry than to lay out how to conduct one that might make a meaningful difference. Precedent is not encouraging – for example, Congress created a Financial Crisis Inquiry Commission after 2008, but it was an unqualified waste of time and money. Still, we urgently need an independent assessment of what went so wrong combined with another providing near-term, actionable reforms. Having served on one post-crisis national commission that did a bit of good, I recommend separating the forensic inquiry from the one focused on the future, guarding against conflicts without eliminating expertise, and assessing only a few clear questions suitable for practical answers that can be readily accomplished under current law.

The first decision point determines all the rest: whether the independent analysis is to be forensic – who dropped which heavy ball on whose toes – or focused on the future – what we learned and what to do about it. Many of the proposals for an independent commission, including the Congressional letter noted above, want their commission to do both, but none could do so well and asking for this is thus asking for trouble.

A good forensic analysis will reduce the moral hazard enjoyed by federal supervisors long exempt from any form of meaningful accountability. That may prevent a near-term repeat of recent debacles, but organizational reforms are notoriously short-lived in complex entities insulated from political and market discipline. Structural change in the corpus of federal rules is thus an even more essential topic to which a separate, even more independent study must quickly turn.

The first challenge for each of these inquiries is who takes them on. GAO is the right place to house forensic review because it's already granted access to confidential examination information and the preliminary report on recent failures shows that it knows what it's doing.

It's harder to pick the right hands into which to put the forward-looking inquiry because anyone with expertise is likely also to have a significant conflict of interest. This is certainly true of the usual suspects for reports of this sort: McKinsey, BCG, and the like. These vast consultancies earn far more from big financial companies and even from the Fed and FDIC than they could ever take home from an assignment of this sort. The same goes for many law firms. Think tanks might do the trick, but most are so wedded to one or another political party as to make their reports immediately suspect to the other side of the aisle.

Academics might seem the answer but for the fact that few have any practical experience in government or finance and most have theories held with doctrinal allegiance. Interest groups are just what their name implies be they focused on financial firms or the best interest presumed to result for consumers or small investors. These are critical considerations, but they must be balanced with other concerns and tempered by compromise.

A truly objective, forward-looking analysis may well need the Almighty, but She's busy. In Her absence, the best course is a small group of retired or near-retired experts, academics, and policy-focused bankers. This is the construct that has worked the best in many independent studies outside financial services and it stands the best chance of success, especially if co-chaired by one former Congressional Democrat and another Republican with policy credibility as well as political clout.

Finally and most importantly: what should the future-focused study address? If this study concludes that finance must be “fairer”, “safer”, or “more competitive” without concrete ways to achieve these worthy goals, then the report may as well just quickly issue a “be the best you can be every day of your life” summation and head home.

What could an independent study meaningfully address? My recommendations start with well-accepted, Congressionally-blessed policy precepts and then brings them down to clear, near-term steps to achieve them.

First, we need to know how to close a big bank without bailout or boondoggle. Congress recognized the urgency of this policy after 2008, enacting laws designed to ensure it, but the FDIC and Fed have been woefully remiss building essential operational readiness. The study should tell the FDIC what it needs to do by when and demand that the final resolution system is saleable, durable, and deployable at a moment’s notice.

Ever since the S&L crisis, Congress has also told regulators to end the forbearance that only deepens the hold into which troubled banks generally dig themselves. Again, the Fed and FDIC have clearly failed to heed this vital edict and the question is an open one at the OCC. As a result, the second goal of a future-focused independent study is to figure out how to force supervisory hands not just by express triggers they must pull, but also the transparency essential to curing all the “culture” problems that have long characterized the federal financial examination framework.

Third, we need a credible M&A construct for banks of all sizes in a financial market increasingly dominated by nonbanks. It’s possible the Justice Department will issue its new bank-merger policy next month, but whether it’s forward-looking or is well integrated with the merger policies the banking agencies have yet to craft is wholly unclear. For all the talk in the White House 2021 competition policy of unduly-concentrated banks, we’ve still got about 4,500 of them. We’ll have far fewer if banks disappear by attrition due to inability to scale up to new technologies and counter nonbanks than we’d ever get from a few more mid-sized mergers accomplished in the context of mandatory, demonstrable resolvability and effective supervision to which the study must also turn.

Are these the only questions for an independent commission? Of course not, but they’re examples of the kind of questions that must be quickly asked and credibly answered if we’re not to keep bouncing downhill to financial crises the regulators promise us can never happen again after each of the crises that came before.