



MEMORANDUM

TO: Federal Financial Analytics Clients
FROM: Karen Petrou
DATE: October 10, 2023

Even after the great financial crisis in 2008, the repo meltdown of 2019, a financial-market bailout of unprecedented proportions in 2020, and three bank failures so far this year, the FDIC and Fed are no closer than they were in 2007 to knowing what to do if a medium-size bank fails, a nonbank barrels down on the banking system, or critical financial-infrastructure flickers. Bond markets are back on the brink and geopolitical risk have become a still-greater concern. The agencies may think new capital and resolution rules are an iron dome allowing them to forego agency repair, but history – see the Gaza Strip – provides no comfort – as I hope we don't have to learn again, fortifications aren't enough in the absence of effective surveillance and rapid response.

The hard truth is the banking agencies after 2008 did what politicians and lawyers know best: they identified gaps in the law that the agencies self-defensively said barred them from preventing a crisis, asking for and then getting a new rulebook without also meaningfully addressing and then correcting their own structural weaknesses. And so it goes again. Thinking dominated by lawyers and politicians – for every successful public leader is a politician no matter his or her nominal independence – is writing lots and lots more rules. Some fix gaps found in the old law and rule, many pave over problems that could have been fixed under old law and rule, and some are as counter-productive as we've noted in past reports and my recent [Congressional testimony](#). Worse, none are designed to ensure agency accountability, financial-institution transparency, or financial stability based on the financial system we have, not the idealized, bank-centric one for which the banking agencies still pine.

I find it helpful to think about the principles of regulation not as a lawyer, but as an engineer. When one does, it's obvious that key axioms of civil-infrastructure design – and that's of course what finance is, civil infrastructure – are entirely and dangerously absent.

Think automobile, air, train and marine transit. In it, there is licensing, training, and operator accountability along with mandatory safety-focused design features and cops enforcing both operator and infrastructure standards. As you will readily see, applying this civil-infrastructure construct to U.S. financial standards instantly reveals a patchwork of partial mandates with glaring, blaring safety-and-soundness omissions.

Of these, the most important is the absence of built-in safety features. We will never, ever be able to prevent financial drag races. What we can do is demand that anyone in a car buckle the seats belts, puts little innocents in regulated car seats, and stays within speed limits regardless of whether they drive a Chevy – think community bank – Maserati – hedge fund – or tractor-trailer – i.e., a SIFI.

And, as with transit, regulators must also build the equivalent of curbs and guardrails, mandate air bags and other involuntary safety features as well as have emergency operations akin to med-evac helicopters and tractor-trailer clean-up equipment. By this I mean mandatory safety-and-

soundness standards – think speed bumps – and, for all vehicles on the financial road, mandatory, involuntary safety features such as systemic regulation for core infrastructure, and – most important of all – recovery and resolution standards preventing a speeding car from ramming the financial-market equivalent of an elementary school.

However, U.S. law in fact requires mandatory safety-and-soundness standards only for anyone willing to get a banking license. Once, anyone who wanted to get on the financial road needed such a license, but the road is now wide, wide open for absolutely anyone with enough money to launch a persuasive website. This wouldn't be so bad if U.S. finance had the other two core features of sound civil infrastructure: mandatory safeguards and sure and certain accident clean-up. But, of course, we don't.

These two grievous failures could have been corrected under current law first by putting meaningful speed bumps and even barriers between licensed banks and everyone else on the road. In short, banks should not lend their cars to unlicensed drivers who won't put on seat belts or stop at signs.

Second and in my view even worse is the inability of the FDIC even now to know what to do when anything other than the bank-equivalent of a Kia runs off the road. Congress gave the Fed, FDIC, and Treasury almost everything they wanted in the 2010 Dodd-Frank Act to ensure that financial fragility could be quickly remedied by immediate intervention and, should that prove insufficient, then also by ready resolution even for the very largest firms under the Bankruptcy Code the agencies' orderly-liquidation authority without taxpayer bailouts.

Mid-March showed how unready the Fed and FDIC are for effective resolution. Even worse, the withering, largely-unnoticed report by the FDIC's [inspector-general](#) about a week ago [found](#) that the FDIC is incapable to this day of doing what congress demanded in 2010: readily deploying its orderly-liquidation authority to take speeding financial companies off the road and, if necessary, clean up after that without toxic consequences or delays that destroy the rest of the financial infrastructure. This combined with the agencies' admission that they also can't supervise even mid-sized banks or shutter them without systemic bailouts is flat-out damning.

In short, we've the worst-possible financial engineering: unlicensed drivers, unsafe roads, no cops at critical intersections, no accident clean-up, and an ironclad guarantee that those who precipitate a crash won't suffer its consequences. Sure, let's clean up the rulebook, but what we need far more are regulators and resolution authorities who act decisively to the best of their ability under the full authority Congress has generously vested in them. Without ready resolution, we'll just keep repeating the crashes that went before with nothing different but the model year and car size.