Federal Financial Analytics, Inc.

MEMORANDUM

TO: Federal Financial Analytics Clients

FROM: Karen Petrou

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It's a hard fact of life that nothing good comes to federal agencies caught up in scandal even when scandal is misplaced. So the real question for the FDIC is whether the bad already all too evident at the divided banking agency will grow still worse, threatening the FDIC's ability to participate in pending rulemakings or, even worse, resolutions. It likely will be no accident if the FDIC comes unglued and the capital and other proposals fall apart. I think new rules will proceed, but the FDIC's threat is far from out of the blue.

Is this cynical? I prefer to think of it as an observation born of experience, but this is a city about which Harry S. Truman famously said, "If you want a friend in Washington, get a dog."

FedFin reports last week tracked Marty Gruenberg's travails before Senate Banking and then again at House Financial Services, with Ranking Member Waters surprisingly aligning herself with her usual GOP enemies when it came to castigating Mr. Gruenberg over sexual-harassment problems at the agency reported by the *Wall Street Journal* as the week of hearings broke two days before.

And, as the hearing went on, Mr. Gruenberg found himself in even more of a pickle. In another uncoincidental moment, Chairman McHenry got wind of 2008 allegations against the chair, allegations Mr. Gruenberg belatedly recalled when prompted by yet another poke from the Journal. Now, Mr. McHenry has opened a formal investigation even as a statement from GOP members of the FDIC board decries the independent investigation Mr. Gruenberg promised as soon as the first news broke because, they say, it's not enough nor is it sufficiently independent.

What next? Could the FDIC grind to a halt? Yes. If it does, do the pending rules stall? Slow they might; disappear, they won't.

First to the FDIC itself. It has always been the weak sister of the three banking agencies, for the most part directly supervising only the smallest banks and managing a deposit-insurance system that every decade or so falls apart due in part to the FDIC's inability to spot trouble coming and design deposit insurance to avert it even after Congress in 1991 gave it ample opportunity to do so. The agency has also long had a notoriously bad supervisory culture, one catalogued in reports that preceded Mr. Gruenberg and would have been hard to clean up even if all the pending investigations now show that Mr. Gruenberg tried his best.

Given its longstanding internal disarray and the far more pitched political battles that now rage around most decisions, the FDIC is particularly vulnerable to dysfunction under even mild stress and that's not what's happening now. Does that mean that no consequential decisions will be made? As I said, don't count the new rules out even if the FDIC is unable to agree on them.

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The reason harks back to the fact that the FDIC supervises the smallest of banks and all of the large ones it supervises now have parent holding companies subject to the Federal Reserve. The one exception to this was First Republic, but it's of course no more precisely because it had only FDIC supervision. Whether the Fed or OCC would have caught the bank's problems any better than the FDIC is most unclear. However, parent holding companies come under FRB rules and the consolidated parent company is where rules count the most to bottom-line realities even in the absence of supervisory rigor.

Thus, even if the FDIC can't pull itself together, the Fed and OCC could issue new capital and long-term debt standards all their own that apply to the IDIs they govern and the parent companies of FDIC-supervised IDIs no matter what the FDIC thinks of them. The FRB and OCC won't want to do this, but they can do this and indeed they've done it before.

In 2013, the FDIC strongly disagreed with the inter-agency Basel III rules the agencies were trying to promulgate in the wake of the great financial crisis. Led by Tom Hoenig, the FDIC felt the FRB and OCC went far too easy on banks by focusing principally on risk-based capital without a binding, tougher leverage ratio. Things got so bad that the Fed and OCC issued the Basel III rules on their own as an interim final rule, noting that they sure hoped the FDIC would come to see it their way. The FDIC conceded at that point because, as noted, it's the weak sister and bowed its head to the biggest boys to preserve its place not only in the U.S. but also at the glamorous global tables FDIC staff love to frequent. Ultimately, the Fed and OCC conceded a bit and the FDIC caved a lot and final Basel III rules became the inter-agency standard known, if far from loved, today.

If the FDIC is again out of the game, Michael Barr and Mike Hsu have to decide if they'll push on. I expect that they will if they can. However, they still can't if enough of the Federal Reserve's board demands substantive change that meets Gov. Bowman at least halfway. Thus, as before the FDIC imbroglio, the deciding factor governing the fate of new rules isn't what the FDIC thinks, it's what the Federal Reserve Board does.